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Prescription for Fulfilling the Promise of a Robust Water Market, A

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A Prescription for Fulfilling the Promise of a Robust Water Market

Scott S. Slater*

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“Growing construction costs and concern for environmental quality have made more difficult the new water supply development designed to meet the projected water deficit.”¹

I. INTRODUCTION

This quote could have been written yesterday. But such were the concerns facing the Governor’s Commission to Review California Water Rights Law as it sought to improve California’s water rights law following a short but severe drought in 1978. The State acknowledged that it was facing substantial existing and projected unmet water supply needs in various regions of California.² Many of these shortage conditions still persist today.³ In 1978, as today, most of the state’s unmet water requirements were linked to the need to augment existing supplies and meet the demands of California’s relentless burgeoning economic and population growth. At times, the problem is more a function of the hydrologic and economic reality that the expected areas for new demand do not match the point of origin for the available supplies. However, the bar has been raised higher and new water is also required to offset losses of supply that have been impaired by contamination,⁴ reclaimed for use by the environment,⁵ and the application of Federal law.⁶

1. GOVERNOR’S COMMISSION TO REVIEW CALIFORNIA WATER RIGHTS LAW, FINAL REPORT 51 (1978) [hereinafter FINAL REPORT].

2. See *id.* at 1 (stating that “[b]y the year 2000 the state’s net demand for water may considerably exceed net dependable supply”).

3. See DEP’T OF WATER RES., CALIFORNIA WATER PLAN UPDATE 1998, EXECUTIVE SUMMARY ES1-2 (Bulletin 160-98) (estimating “that California’s water shortages at a 1995 level of development are 1.6 maf in average water years, and 5.1 maf in drought years”); *Drought Update Indicates Fifth Consecutive Year of Drought: Drought Conditions in West*, WATER STRATEGIST, at 10 (May 2004) (stating that “Lake Powell is expected to receive 50 percent of normal spring inflow, and the Lake was at 42 percent of live capacity in Spring 2004”); Sue McClurg & Glenn Totten, *The Ties that Bind: The Evolving Policy of the Colorado River*, WESTERN WATER, at 4, 10 (March/Apr. 2004) (quoting Reclamation Commissioner John Keyes as saying “[w]e are on the cusp of one of the most severe droughts on record . . . this drought is even worse than the Dust Bowl years during the 1930’s”).

4. See Gary Pitzer, *Confronting a Legacy of Contamination: Perchlorate*, WESTERN WATER, at 4-13 (May/June 2003) (exploring the threat of perchlorate contamination in California). Presently pending cases seeking to address perchlorate contamination include *Southern California Water Co. v. Aerojet Gen. Corp.*, No. CV 02-6340 ABC (RCx) (C.D. Cal.) and *American States Water Co. v. Aerojet Gen. Corp.*, No. 99 AS 05947 (Super. Ct. Sacramento County).

5. *Nat’l Audubon Soc’y v. Superior Court*, 658 P.2d 709, 714-15 (Cal. 1983); *Cal. Trout, Inc. v. State Water Res. Control Bd.*, 255 Cal. Rptr. 184 (Ct. App. 1989); *United States v. State Water Res. Control Bd.*, 227 Cal. Rptr. 161 (Ct. App. 1986); Central Valley Project Improvement Act (CVPIA) Reclamation Projects Authorization and Adjustments Act of 1992, Pub. L. No. 102-575 § 3406(b)(2), 106 Stat. 4600, 4715-4716 (1992).

6. See U.S. Bureau of Reclamation, Lower Colorado Region: The Law of the River, at <http://www.usbr.gov/lc/region/g1000/lawofrvr.html> (last visited Oct. 17, 2003) (copy on file with the *McGeorge Law Review*); Central Valley Project Improvement Act (CVPIA) Reclamation Projects Authorization and Adjustments Act of

The Final Report of the Commission and the legislation enacted in furtherance of its recommendations made it the official position of the State of California to encourage water transfers as a means of more efficient statewide water use.⁷ In short, the Governor's Commission believed that relatively simple and focused reforms in water law could effectuate a more efficient water use and thereby serve to reduce the projected deficit in water supplies.⁸ Specifically, the failure to address the conditions necessary to encourage investment in improved water use efficiency would ultimately lead to the widening of the gap between supply and demand, substantial economic waste, and the failure to reach our State's economic potential. Accordingly, the Final Report of the Governor's Commission considered two primary pathways to increase water use efficiency: first, through more extensive administrative regulation of water use; and second, through the creation of market-based incentives that would result from legislative and judicial support for water transfers.⁹

Just five years earlier, the National Water Commission had recommended legislative intervention to provide direction through the adoption of legislatively defined standards for reasonable and beneficial use within a specific region.¹⁰ While the Governor's Commission failed to endorse this specific recommendation, it did elect to advocate some modest changes in broadening the standard for demonstrating beneficial use¹¹ and buttressing the California State Water Resources Control Board's ("SWRCB") regulatory oversight of water use by extending its administrative authority to issue cease and desist orders and to pursue civil penalties.¹²

The strongest recommendations, however, were directed toward the creation of a climate for more extensive investments in conservation and for facilitating water markets.¹³ Indeed, without an active water market, which offers a realistic hope to those thirsty users seeking an orderly redistribution of existing water supplies, the more populated and often more desperate regions of the State are likely to pursue other options.¹⁴ Actual experience in the hunt to augment

1992, Pub. L. No. 102-575 § 3406(b)(2), 106 Stat. 4600, 4715-4716 (1992); WATER EDUC. FOUND., LAYPERSON'S GUIDE TO THE CENTRAL VALLEY PROJECT 14 (2002) (noting that the CVPIA "reallocated 800,000 acre-feet of CVP yield (600,000 acre-feet in a dry year) to restore valley fisheries").

7. See CAL. WATER CODE §§ 380-387, 475 (West Supp. 2005); see also *id.* §§ 1810-1814.

8. FINAL REPORT, *supra* note 1, at 51.

9. See *id.* at 57-69.

10. NAT'L WATER COMM'N, WATER POLICIES FOR THE FUTURE: FINAL REPORT TO THE PRESIDENT AND TO THE CONGRESS OF THE UNITED STATES 305 (1973).

11. FINAL REPORT, *supra* note 1, at 71 (recommending a modification of the custom, standard, and habit criteria to serve as merely one factor in making the determination of whether a given use was beneficial).

12. *Id.* at 59.

13. *Id.* at 60-62.

14. David E. Lindgren, *The Colorado River: Are New Approaches Possible Now that the Reality of Our Allocation is Here?*, 38 ROCKY MTN. MIN. L. INST. 25-1, 25-3 (1992); see ROBERT GOTTLIEB & MARGARET FITZSIMMONS, THIRST FOR GROWTH: WATER AGENCIES AS HIDDEN GOVERNMENT IN CALIFORNIA 79-80, 84-85 (1991); see also LEONARD S. HYMAN ET AL., THE WATER BUSINESS: UNDERSTANDING THE WATER SUPPLY AND WASTEWATER INDUSTRY 245 (1998).

available supplies has merely reaffirmed the need for water transfers and further serves to provide additional impetus to break down the remaining barriers to a fully developed water market.¹⁵

As was the case in 1978, water transfers continue to occur regularly and routinely on a regional or local level. However, if the people of California intend to simultaneously meet future water supply demands and manage water resources on a sustainable basis, then substantial progress must be made in the area of securing access to publicly owned conveyance facilities, frequently called "wheeling,"¹⁶ and in creating an orderly process to measure and consider third-party impacts so as to improve local support for inter-regional transfers.¹⁷

II. THE BUYER'S OPTIONS

Since 1978, other than water transfers, the three options most frequently pursued by potential buyers seeking to bridge the gap between supply and demand estimates have been: (a) demand management; (b) new water supply development; and (c) utilitarian reallocation. Each approach has enjoyed some modest success in the years following the Commission Report, but water transfers continue to hold the greatest promise.

A. Demand Management

Some areas of the State have undertaken dramatic water conservation programs and maximized the use of recycled water in a variety of settings. Continuing legislative efforts have focused on creating incentives for and even requiring various forms of conservation, and California's urban water purveyors have adopted and pursued best management practices. There are probably a number of reasons why conservation successes have substantially dampened new

15. "The application of market forces can be an effective way to achieve a balance between supply and demand, to facilitate efficiency by disclosing non-competitive and inefficient water users and to stimulate use of technical and procedural innovations to maximize water use efficiency." WATER TRANSFER WORKGROUP, WATER TRANSFER ISSUES IN CALIFORNIA: FINAL REPORT TO THE CALIFORNIA STATE WATER RESOURCES CONTROL BOARD 6 (June 2002); see also David H. Getches, *Water Wrongs: Why Can't We Get it Right the First Time*, 34 ENVTL. L. 1, 12-14 (2004).

16. During the first year of operation, the Environmental Water Account ("EWA") obtained 264,000 acre-feet from transfers. WATER TRANSFER WORKGROUP, *supra* note 15, at 5. The State Water Bank was established in 1991, and in that year, purchased rights to use 821,000 acre-feet of water from willing suppliers to sell to entities with critical needs. *Id.* at 4. Access to pumping plants in the Sacramento/San Joaquin Delta and canal capacities are major factors in accomplishing water transfers from the northern portions of the Central and Southern areas of California. *Id.*

17. See Ellen Hanak & Caitlin Dyckman, *Counties Wrestling Control: Local Responses to California's Statewide Water Market*, 6 U. DENV. WATER L. REV. 490 (2003). The legitimacy of community impacts is open to debate. See Charles V. Moore, *Discussion*, in WATER SCARCITY: IMPACTS ON WESTERN AGRICULTURE 266, 268-269 (Ernest A. Englebert & Ann Foley Scheuring, eds., 1984).

demands in metropolitan areas,¹⁸ and further progress is clearly still possible.¹⁹ However, there are limits to what can be accomplished through conservation.²⁰

From time to time, there have been more extreme local efforts to legally preclude the creation of new demands, rather than seek a more efficient distribution of resources. In the early 1970s, the support for better demand management converged with a growing public sentiment that urban sprawl should be controlled through prohibition of the extension of utility services. Almost overnight, demand management was transformed into a strategy for effectuating growth control.²¹

18. The Los Angeles Department of Water and Power installed water meters early in the twentieth century, and has encouraged the installation of both low-flow showerheads and ultra-low-flush toilets. See Los Angeles Department of Water and Power, *Water Past and Present: Conservation Efforts*, at <http://www.ladwp.com/ladwp/cms/ladwp001627.jsp> (last visited Oct. 17, 2004) (copy on file with the *McGeorge Law Review*). The Metropolitan Water District of Southern California has both residential and commercial rebate and incentive programs in order to encourage conservation, and additionally has programs regarding water-wise landscaping and the watering of lawns and gardens. Metropolitan Water District of Southern California, *Conservation and the Environment*, at <http://www.mwdh2o.com/mwdh2o/pages/conserv/conserv01.html> (last visited Oct. 17, 2004) (copy on file with the *McGeorge Law Review*). Estimates suggest that extensive conservation could supply water for a million people. See Getches, *supra* note 15, at 13-14. The Santa Clara Valley Water District has different programs to foster water conservation in homes, landscaping, business, and agriculture. See Santa Clara Valley Water District, *Water Conservation*, at http://www.valleywater.org/Water/Water_conservation/index.shtml (last visited Oct. 17, 2004) (copy on file with the *McGeorge Law Review*). The San Diego County Water Authority invests more than \$1 million each year in conservation programs including the installation of water-saving fixtures and appliances, as well as residential surveys, landscape, and agricultural audits. San Diego County Water Authority, *Water Conservation: A Way of Life in San Diego County* (Oct. 2003), available at http://www.sdcwa.org/manage/pdf/Conservation10_03.pdf (copy on file with the *McGeorge Law Review*).

19. Barton Thompson, *Institutional Perspectives on Water Policy and Markets*, 81 CAL. L. REV. 671, 700, 755-56; 759-60 (1993). The California Water Code also now mandates that recycled water be used when available in certain situations. See CAL. WATER CODE § 13553(a) (West 1992 & Supp. 2005) (use of potable water for toilet flushing when recycled water is available is a waste under Article X, Section 2 of the California Constitution); *id.* § 13550 (the use of potable domestic water for nonpotable uses, including cemeteries, golf courses, parks, highway landscaped areas, and industrial and irrigation uses is a waste or an unreasonable use of the water within the meaning of Article X, Section 2, if recycled water is available); Getches, *supra* note 15, at 14.

20. "Despite SDCWA's tremendous successes in maximizing existing water supplies through water conservation and BMPs, these measures alone are not sufficient to supply projected new demand over the next twenty years. Anticipated population growth in the San Diego County region, and thus increased demand, will require additional water resources/supplies." Expert Witness Statement of Kenneth Weinberg, *In re* Petition of Imperial Irrigation District and San Diego County Water Authority for Approval of Long-Term Transfer of Conserved Water and Changes in Point of Diversion, Place of Use and Purpose of Use Under Permit No. 7643, at 8 (SWRCB, Mar. 22, 2002) (copy on file with the *McGeorge Law Review*).

21. Many local agencies adopted water shortage emergency declarations. Moratoria preventing the issuance of new urban water connections were used to defer, and in some cases deny, new development in vast portions of the State's Central Coast region. A decade later and following a plethora of unsuccessful legal challenges, the moratoriums remained in existence. The cases reviewing the moratoria have accepted broader notions of what constitutes an "emergency." No longer can an emergency be considered a temporary, sudden, or unexpected condition. Rather, emergency had become a semi-permanent condition and a matter of political choice. Ultimately, this experiment in demand management ended when the catastrophic economic consequences of prolonged drought in the early 1990s turned the tide. See *Swanson v. Marin Mun. Water Dist.*, 128 Cal. Rptr. 485 (Ct. App. 1976); *Hollister Park Inv. Co. v. Goleta Water Dist.*, 147 Cal. Rptr. 91 (Ct. App. 1978); *Bldg. Indus. Ass'n v. Marin Mun. Water Dist.*, 1 Cal. Rptr. 2d 625 (Ct. App. 1991); *Bank of Am. Nat'l Trust & Sav. Ass'n v. Summerland County Water Dist.*, 767 F.2d 544 (9th Cir. 1985); *Wilson v. Hidden Valley*

Today, virtually all of the water shortage emergency measures adopted between 1973 and 1980 have now been repealed, and the theory that communities could control growth by overriding real demands has been largely discredited.²² The process now appears to have come full circle, with the requirements for new and reliable water being a necessary prerequisite to the approval of large development. Local agencies are required to make findings regarding the adequacy of their available water as a precondition to the issuance of land use clearance.²³ At the same time, local agencies have continued to squeeze existing users more tightly to foster and compel conservation.²⁴ If sustainable development is the model and new water is necessary, it will likely have to come from either new projects or water transfers.

B. New Projects

A second approach to secure additional water and one that dominated the early development of water supplies in the West,²⁵ and still frequently considered by water shortage areas, is the development of new water supplies through a combination of physical projects such as off-stream storage and desalination. However, water supply projects remain controversial and typically very costly.²⁶

Mun. Water Dist., 63 Cal. Rptr 889 (Ct. App. 1967); Bldg. Indus. Ass'n v. Marin Mun. Water Dist., 1 Cal. Rptr. 2d 625 (Ct. App. 1991). *But see* Lockary v. Kayfetz, 917 F.2d 1150 (9th Cir. 1990).

22. The economic losses attributed to the drought in 1989-1992 were enormous. *See generally* State Water Resources Control Board, *Hearings Program-Cachuma Project Hearing*, at <http://www.waterrights.ca.gov/hearings/cachumahearing.htm> (last visited Oct. 17, 2004) (copy on file with the *McGeorge Law Review*) (Hearing to Review the U.S. Bureau of Reclamation Water Right Permits 11308 and 11310 (Application 11331 and 11332) to determine whether any modifications in permit terms or conditions are necessary to protect public trust values and downstream water rights on the Santa Ynez River below Bradbury Dam (Cachuma Reservoir)). Water connection moratoriums of the Goleta Water District, the City of Santa Barbara, the Summerland County Water District, the Montecito Water District, and the Marin Municipal Water District were all repealed in the early 1990s. *See also* Lockary v. Kayfetz, 917 F.2d 1150 (9th Cir. 1990) (suggesting that the failure to provide service connections to new users may constitute a takings and a violation of substantive due process). However, a quasi-moratorium on service connections in the Monterey Peninsula remains in existence today and is administered by the Monterey Peninsula Water Management District. *See* CAL. WATER CODE app. § 118-363 (stating that no person shall create a water distribution system within the Monterey Peninsula Water Management District without district approval).

23. CAL. WATER CODE §§ 10910-10915 (West Supp. 2005); CAL. GOV'T CODE §§ 65867.5, 66455.3, 66473.7 (West 1997 & Supp. 2005); *see also* Stanislaus Nat'l Heritage Project v. County of Stanislaus, 55 Cal. Rptr. 2d 625 (Ct. App. 1996) (environmental impact report must present full analysis of water supplies even for planned projects); County of Amador v. El Dorado County Water Agency, 91 Cal. Rptr. 2d 66 (Ct. App. 1999) (failure to analyze growth inducing impacts of new storage facilities).

24. *See* CAL. WATER CODE § 526 (West Supp. 2005) (requiring the installation of water meters for all urban water suppliers receiving water from the Central Valley Project); A.B. 2572, 2004 Cal. Stat. ch. 884 (requiring all urban water suppliers to begin the installation of water meters).

25. *See* WATER EDUC. FOUND., LAYPERSON'S GUIDE TO THE STATE WATER PROJECT 17 (2004). The State Water Project ("SWP") represents one of the largest infrastructure investments ever and is the largest state-built multi-purpose water projects in the U.S. *Id.* at 10.

26. *See id.* at 23; Getches, *supra* note 15, at 14. CALFED is under a 30-year schedule to implement long-term water storage and conveyance so as to provide a reliable water supply. WATER EDUCATION FOUNDATION, *supra* note 25, at 23.

Despite some limited breakthroughs, like the \$2.1 billion dollar East-Side Diamond Valley Lake water storage project recently completed by the Metropolitan Water District of Southern California (“MWD”), the prospects for further off-stream storage facilities appear dim.²⁷ Storage projects are fiercely contested by environmental interests and the expenses associated with permitting and building reservoirs are often so substantial so as to preclude or at least dissuade actual construction.²⁸

Even desalination of ocean and brackish water has its share of detractors.²⁹ While there is nothing inherently wrong with the support of a proper mix of water supply development projects, public stewardship, economic efficiency, and environmental responsibility, the public deserves a relatively complete and transparent analysis of water supply options.³⁰

C. Utilitarian Reallocation

A third approach often pursued to obtain additional water supplies has been to mount a direct assault against the legal basis for the priority of the rights enjoyed by existing users.³¹ By seeking a reallocation of water through the application of legal theories, such as the doctrine of equitable apportionment or by asserting that the law requires not just beneficial but optimal use,³² junior priority rights hope to secure water presently enjoyed by existing users without compensation.³³

27. See Molly Dugan & Han Kwak, *Anglers Find a Jewel: Diamond Valley Lake Rewards Patience with Catches*, PRESS-ENTERPRISE (Oct. 4, 2003), available at http://www.pe.com/digitalextra/metro/diamondvalley/vt_stories/PE_NEWS_nlake04.a124c.html (copy on file with the *McGeorge Law Review*).

28. Thompson, *supra* note 19, at 676, 702. “As environmental opposition, tight budgets, and a reduced number of remaining sites have reduced the opportunity for engineering solutions, a growing number of cities have also recognized that water trades may be one of the few realistic means available to meet their increasing demands.” *Id.* at 702 n.109.

29. For a critique on the issues and concerns associated with desalination projects, see CAL. COASTAL COMM’N, SEAWATER DESALINATION AND THE CALIFORNIA COASTAL ACT (March 2004).

30. “Hidden water subsidies, however, produce other ‘hidden’ taxes, such as tax dollars needed to pay for extremely expensive water reclamation projects. Many governments are finding that this may not be the most cost-effective use of the natural resource.” Getches, *supra* note 15, at 14. “The physical and political circumstances are such that big government can no longer build more dams or canals to help with water shortages.” *Id.* at 250.

31. Clifford W. Shulz & Gregory S. Weber, *Changing Judicial Attitudes Towards Property Rights in California Water Resources: From Vested Rights to Utilitarian Reallocation*, 19 PAC. L.J. 1031, 1064 (1988).

32. Compare *Imperial Irrigation Dist. v. State Water Res. Control Bd.*, 275 Cal. Rptr. 250, 260-61 (Ct. App. 1990) with *Big Bear Mun. Water Dist. v. Bear Valley Mut. Water Co.*, 254 Cal. Rptr. 757 (Ct. App. 1989) (questioning whether Article X, Section 2 requires reasonable use or optimal use).

33. See Lindgren, *supra* note 14, at 25-3; GOTTLIEB & FITZSIMMONS, *supra* note 14, at 79-80, 84-85.

While it may be true that water is a public resource,³⁴ there is nothing incompatible with protection of the public interest in water supply development and the recognition of private property rights in water.³⁵ Since 1978, the desire to protect and secure water for environmental values was partially addressed through the recognition and application of the public trust doctrine.³⁶ Likewise, the safe annual yield of a groundwater basin places a legal limit on the quantity of groundwater that may be harvested annually.³⁷

Efforts to reclaim water from consumptive uses as part of an environmental baseline can be reasonably accommodated within an evaluation of water availability. However, consumptive users with junior water rights have sought to pursue another strategy—one that is not focused on identifying the resource baseline but on challenging the very rules of priority by offering instead allocation criteria that is “needs” based under the guise of promoting “optimal use.”

The strategy of socialized redistribution of water is rationalized by rhetoric that because water rights are a “public resource” and not private property, water may be distributed in accordance with modern visions of public need in lieu of property rights. There are many problems in an allocation strategy that seeks to cast aside the certainty provided by property rights in favor of transcendent use, not the least of which is endless litigation and legislation to establish the highest “need” of the “public resource.” The greatest irony is that those that propose uncompensated redistribution in the name of optimal use do so at the risk of discouraging further investments in conservation and thereby perpetuate the inefficient use that they strenuously criticize.³⁸

In practice, therefore, a landowner seeking to transfer conserved water derived from native supplies, section 1011 notwithstanding, likely must limit the amount it may transfer to the amount of water it had been consumptively using: a result which on its face is inconsistent with the espoused purpose of the conservation statutes. In reality, the decision suggests that section 1011 is not to

34. *State v. Riverside County Superior Court*, 93 Cal. Rptr. 2d 276, 281-82 (Ct. App. 2000); see *City of San Bernardino v. City of Riverside*, 198 P. 784, 794 (Cal. 1921)

35. *In re Waters of Long Valley Creek Stream Sys. v. State Water Res. Control Bd.*, 599 P.2d 656, 672-73 (Cal. 1979); *Wetherill v. Brehm*, 240 P. 529, 533 (Cal. 1925); *Wright v. Best*, 121 P.2d 702, 710-11 (Cal. 1942); *Riverside County Superior Court*, 93 Cal. Rptr. 2d at 281-82; *Schimmel v. Martin*, 213 P. 33, 34 (Cal. 1923); see CAL. STATE BD. OF EQUALIZATION, ASSESSOR'S HANDBOOK SECTION 542: ASSESSMENT OF WATER COMPANIES AND WATER RIGHTS, PART II, at 5 (Dec. 2000). See generally *Nat'l Audubon Soc'y v. Superior Court*, 658 P.2d 709 (Cal. 1983).

36. *Nat'l Audubon Soc'y v. Superior Court*, 658 P.2d 709 (Cal. 1983); see Gregory S. Weber, *Articulating the Public Trust: Text, Near-Text and Context*, 27 ARIZ. ST. L.J. 1155 (1995).

37. See *City of Pasadena v. City of Alhambra*, 207 P.2d 17 (Cal. 1949); *City of San Fernando v. City of Los Angeles*, 537 P.2d 1250 (Cal. 1975).

38. *Ariz. v. Cal.*, 460 U.S. 605, 620 (1983); Shulz & Weber, *supra* note 31, at 1064; see FINAL REPORT, *supra* note 1, at 22-25; *Long Valley*, 599 P.2d at 656; Stuart L. Somach & Andrew M. Hitchings, *Antitrust Considerations in Water Marketing*, 11 NAT. RESOURCES & ENV'T 26 (Fall 1996).

be applied in a manner that overrides the rights of junior users to return flows from native water. Ignoring, for the moment, the practical problems of utilitarian reallocation and pitting each water user against every other in an endless process of litigation to determine relative inter se priority, perhaps the greatest irony is that those who propose such uncompensated redistribution are supporting inefficient resource management and have been found to foster the very uncertainty other unsuitable to conditions in the arid west.

III. WATER TRANSFERS

A. *The Approach*

A more direct approach to meeting the State's water supply deficit, which was endorsed by the Governor's Commission,³⁹ is to seek an increase in the efficiency of water use and distribution that might be effected through the removal of barriers to water transfers and increasing incentives and protections for potential water transferors. In theory, with proper incentives, an existing user might be enticed to modify its existing water use practices and voluntarily transfer water from one to another.

Most of the Commission's focus on transferability related to surface water supplies and, in particular, its desire to address the SWRCB's role in approving transfers.⁴⁰ The barriers were identified and in many instances the Legislature promptly responded with new laws or clarifications of other laws designed to allow water to be more freely traded. To that end, the Commission recommended providing greater certainty for water rights in California and several key additions to the California Water Code.⁴¹

B. *Conservation-Based Transfers*

Of all the Commission's recommendations, Water Code section 1011 has been the most noteworthy. Water Code section 1011 states that one holding an appropriative water right who fails to use a portion of that water, due to conservation measures, will be deemed to have put that conserved water to beneficial use.⁴² The conserved water, or the right to its use, may then be transferred to another water user.⁴³ This mechanism was recommended by the

39. See FINAL REPORT, *supra* note 1, at 60-62.

40. See generally *id.* at 62-96; see also Clifford T. Lee, Governor's Commission to Review California Water Rights Law, The Transfer of Water Rights in California (Staff Paper No. 5, Dec. 1977) (addressing the transferability of water).

41. See generally FINAL REPORT, *supra* note 1, at 16-47.

42. CAL. WATER CODE § 1011(a) (West Supp. 2005).

43. *Id.* § 1011(b).

Governor's Commission, as a foil to the forfeiture doctrine's discouragement of water conservation.⁴⁴

Conservation-based transfers continue to hold particular promise because they avoid further pressure on other available supplies to support the transfer as would be the case if the transferor merely intends to shift to groundwater. Moreover, because the conservation activity is designed to make existing uses more efficient, the subsequent transfer of the saved supplies should not cause adverse third-party economic impacts.⁴⁵ Indeed, the conservation activities can actually provide an economic stimulus above and beyond the baseline condition.⁴⁶

In one of the SWRCB's more significant decisions in recent years, the SWRCB addressed exactly what a water transfer pursuant to a section 1011 conservation program would encompass.⁴⁷ The SWRCB found that, despite the fact that a water district had engaged in an applicable conservation program under section 1011 and actually saved more than 18,000 acre-feet, third parties and the environment were already using the vast majority of the water that had been conserved.⁴⁸ Accordingly, the SWRCB limited its approval of the transfer to approximately ten percent of the conserved amount.⁴⁹

In practice, therefore, a landowner seeking to transfer conserved water derived from native supplies, section 1011 notwithstanding, likely must limit the amount it may transfer to the amount of water it had been consumptively using—a result which on its face is inconsistent with the espoused purpose of the conservation statutes to provide credit to a water right holder for not using water. In reality, the decision suggests that section 1011 is not to be applied in a manner that overrides the rights of junior users to return flows from native water.⁵⁰

44. FINAL REPORT, *supra* note 1, at 60.

45. See S.W.R.C.B., Revised Order No. WR 2002-13 (Dec. 20, 2002) [hereinafter SWRCB Revised Order WR 2002-13]. The SWRCB, in the transfer from Imperial Irrigation District to the San Diego County Water Authority, found that "[t]he record establishes, however, that the transfer will not result in substantial injury to any third-party water right holder." *Id.* at 22.

46. See *id.* at 75. The SWRCB found that the implementation of conservation measures could result in the creation of over 700 jobs and an increase in personal income of \$25 million dollars per year. *Id.*

47. See S.W.R.C.B., Order No. WR 2003-01 (2003) [hereinafter SWRCB Order WR 2003-01] (where the water right to be transferred may have been forfeited for nonuse).

48. *Id.*

49. *Id.*

50. See, e.g., CAL. WATER CODE §§ 1005.2-1017 (West 1971 & Supp. 2005). If engaged in conservation efforts for many years prior to seeking to effect a transfer, a transferor should be able to expect that the quantity of water available for transfer will not be diminished. *Id.* § 1011.

Another important SWRCB decision reviewing the application of section 1011 suggests that a consumptive use savings that will be transferable under the Water Code⁵¹ may be established in two separate ways.⁵² First, conservation efforts may be identified that will be implemented in the year of the transfer and the associated consumptive use savings may be calculated accordingly.⁵³ Second, a historic savings due to water conservation efforts implemented in years prior to the transfer may be established, which will continue to be implemented in the year of the transfer.⁵⁴

Conservation and transfer of foreign or imported water, however, is subject to different considerations. Because an importer cannot be compelled to continue the importation for the benefit of third parties,⁵⁵ in most cases an importer can expect to be able to transfer the full amount of water conserved. Presumably, this same rationale can be applied where water being transferred is held in storage, and therefore would be beyond the priority call of riparians and appropriators that hold rights to native supplies.⁵⁶

Despite the advantages of conveying foreign or imported water, if fish and wildlife have become dependent on the continuance of return flows, junior uses that might otherwise be unable to challenge a senior water user's potential transfer may receive consideration in the SWRCB transfer approval process.⁵⁷ An example of such consideration can be seen in the transfer between the Imperial Irrigation District ("IID") and the San Diego County Water Authority ("SDCWA"), discussed *infra*, in which the SWRCB exercised extensive scrutiny related to the effect the transfer might have on tailwater returns to the Salton Sea.⁵⁸

51. *Id.* § 1725.

52. See S.W.R.C.B., Order No. WR 99-12, at 21-22 (Dec. 28, 1999) [hereinafter SWRCB Order WR 99-12]; S.W.R.C.B., Order No. WR 2000-01, at 14 (Mar. 15, 2000) [hereinafter SWRCB Order WR 2000-01].

53. SWRCB Order WR 99-12, *supra* note 52, at 21-22; SWRCB Order WR 2000-01, *supra* note 52, at 14.

54. SWRCB Order WR 99-12, *supra* note 52, at 21-22; SWRCB Order WR 2000-01, *supra* note 52, at 14. In order to obtain an accurate measurement of any consumptive use savings resulting from water conservation efforts, average consumptive use per acre before implementation of conservation efforts should be compared to average consumptive use following implementation.

55. See *Stevens v. Oakdale Irrigation Dist.*, 90 P.2d 58, 60-62 (Cal. 1939).

56. See SWRCB Order WR 99-12, *supra* note 52, at 22-27; SWRCB Order WR 2000-01, *supra* note 52, at 14-15.

57. Such potential examples include an environmental impact under the California Environmental Quality Act, a potential take of a threatened or endangered species, or an affected fish, wildlife, or other instream beneficial use. SCOTT S. SLATER, CALIFORNIA WATER LAW AND POLICY 10-10 (2003); see SWRCB Order WR 99-12, *supra* note 52, at 22-27; SWRCB Order WR 2000-01, *supra* note 52, at 14-15.

58. See *infra* Part IV.C.; SWRCB Revised Order WR 2002-13, *supra* note 45.

C. Improved Conditions for a Thriving Market: Increased Certainty

Consistent with prevailing economic theory, the Governor's Commission sought greater certainty for water rights in California that would foster investment and greater improvements in efficiency.⁵⁹ The Commission based its recommendations on its belief that "a property rights system in water which permits voluntary transfers encourages the shift in resources from lower-value uses to higher-value uses."⁶⁰ Allowing a water right to be "traded" in a market context promotes efficiency, as water may then be utilized by those who value it most. A system in which water rights may not be traded and sold will not produce incentives for one to maintain such rights, as discussed *supra*.

The California Supreme Court appeared to immediately get the message. In the first five years following the issuance of the Governor's Commission Report, it issued two important decisions that acknowledged certainty as the dominant public policy underpinning for countenancing the subordination of long-dormant riparian rights in *In re Waters of Long Valley Creek Stream System v. SWRCB*⁶¹ in 1978, and again two years later discrediting the view that prescriptive rights could be used to curtail the State's plenary power over the appropriation of surface water in *People v. Shirokow*.⁶²

The Supreme Court's decision in *National Audubon Society v. Superior Court*⁶³ and the Court of Appeal decision in *United States v. SWRCB*⁶⁴ notwithstanding, there has not been any significant erosion of the protected character of water rights as species of water rights. In fact, in the twenty-five years since the issuance of the Governors Commission Report, the Courts have consistently resolved all doubts as to whether water rights are property under California Law⁶⁵ and protected against takings without compensation.⁶⁶

59. The need for certainty in rules regarding species of real property has long been acknowledged by the United States Supreme Court. Justice Brennan once wrote that nowhere is certainty more important than in the Western water rights allocation systems. See *Ariz. v. Cal.*, 460 U.S. 605, 620 (1983); *Getches, supra* note 15, at 12 (stating that "[t]he great virtue of creating property rights in water—the right to use water is itself property—is that it can be bought and sold").

60. FINAL REPORT, *supra* note 1, at 62. "The Application of market forces can be an effective way to achieve a balance between supply and demand, to facilitate efficiency by disclosing non-competitive and inefficient water users and to stimulate use of technical and procedural innovations to maximize water use efficiency." WATER TRANSFER WORKGROUP, *supra* note 15, at 6.

61. 599 P.2d 656, 666 (Cal. 1979) (stating that "uncertainty concerning the rights of water users has pernicious effects").

62. 605 P.2d 859, 866 (Cal. 1980) (stating that "the board is hindered in its task by any uncertainty as to the availability of water for appropriation").

63. 658 P.2d 709 (Cal. 1983).

64. 227 Cal. Rptr. 161 (Ct. App. 1986).

65. See, e.g., *State v. Riverside County Superior Court*, 93 Cal. Rptr. 2d 276, 281-82 (Ct. App. 2000) (water rights are a species of real property); *United States v. Gerlach Live Stock Co.*, 339 U.S. 725, 736 (1950) (acknowledging that Congress has recognized the property status of water rights vested under California law); *County of San Joaquin v. State Water Res. Control Bd.*, 63 Cal. Rptr. 2d 277, 285 n.12 (Ct. App. 1997); *United*

Even the implementation of the *National Audubon* decision has served primarily to support the SWRCB's efforts to balance the ongoing needs of the environment and consumptive water uses. Viewed through another lens, the preferred and widely acknowledged benefit of managing water resources on a "sustainable use" or "safe yield" basis has long been the hallmark of groundwater adjudications in California.⁶⁷ In many ways, *National Audubon* merely brought the law of surface water into a closer alignment with groundwater by establishing a baseline for water availability.

The notion that an appropriator could take water free of any similar responsibility to an environmental baseline seems anathema to any notion of modern water law and policy. At its core, the *National Audubon* case addressed the question of whether water historically taken by the City of Los Angeles was technically still "available" as distinguished from the relative priorities of competing users. In the end, the result of the case was effectively the imposition of a similar responsibility on surface water users instead of allowing the potentially irreversible degradation of water resources.⁶⁸ In any event, in practice, the public trust doctrine has had very little adverse impact on the general certainty of water rights in California.⁶⁹

It must be conceded that the Court of Appeal's decision in *United States v. SWRCB* is often cited for the proposition that the SWRCB may elect to disregard traditional priorities when acting in its dual functions of water rights and water quality administration. While the express language of the opinion may admittedly authorize some level of adjustment between the relative priority of appropriators by the SWRCB,⁷⁰ there have been no further reported decisions that elaborate on the extent of the SWRCB's duties and discretion in accommodating its dual water rights and water quality functions or, more importantly, the circumstances that would warrant ignoring seniority as the basis for establishing priority among competing appropriators.

Even more recently, purely equitable balancing of interests as a method of apportioning water among competing groundwater right holders was dealt its death knell in *City of Barstow v. Mojave Water Agency*.⁷¹ While the SWRCB is

States v. State Water Res. Control Bd., 227 Cal. Rptr. 161, 168 (Ct. App. 1986); Schimmel v. Martin, 213 P. 33, 34 (Cal. 1923).

66. See, e.g., Tulare Lake Basin Water Storage Dist. v. United States, 59 Fed. Cl. 246 (2003); Tulare Lake Basin Water Storage Dist. v. United States, 49 Fed. Cl. 313 (2001); Hage v. United States, 51 Fed. Cl. 570 (2002); United States v. Gerlach Live Stock Co., 339 U.S. 725, 963 (1950).

67. See City of Los Angeles v. City of San Fernando, 537 P.2d 1250 (Cal. 1975); City of Pasadena v. City of Alhambra, 207 P.2d 17 (Cal. 1949); Wright v. Goleta Water Dist., 19 Cal. Rptr. 740 (Ct. App. 1985). The safe yield limitation includes protection against environmental harm; e.g., salt-water intrusion, water quality degradation, and subsidence.

68. See Cynthia Koehler, Water Rights and the Public Trust Doctrine: Resolution of the Mono Lake Controversy, 22 ECOLOGY L.Q. 541, 547-49 (1995).

69. Weber, *supra* note 34, at 1238-39; see Koehler, *supra* note 68, at 556-59.

70. United States v. State Water Res. Control Bd., 227 Cal. Rptr. 161, 189 (Ct. App. 1986).

71. 5 P.3d 853 (Cal. 2000).

generally charged with a broader administrative responsibility than an individual court, other than rules of procedure, the differences between the SWRCB conducting a general stream adjudication and a court presiding over a comprehensive groundwater adjudication are not readily discernable. The SWRCB does have a responsibility to manage and administer water quality values. However, a court is not free to disregard public trust resources and its self-executing duties pursuant to California Constitution, article X, section 2, which clearly extends to water quality.⁷² Thus, while the physical solution doctrine and perhaps other equitable considerations may support reasonable accommodations among competing claimants, they do not justify imposing material burdens on a paramount water right holder.⁷³

The progression of the common law represented by these decisions as a whole is significant because they serve to close a number of doors through which some potential water buyers had sought to contest the historical basis for determining rules of water rights priorities.⁷⁴ If the holders of water rights are secure against challenges to their fundamental priority, the holders of the junior water rights, as well as potential trading partners, will be encouraged to make investments in improved efficiency by senior users so as to enjoy the savings from conserved water through a water transfer.⁷⁵

D. Active Regional Trading Continues

Today, water transfers are a common if not preferred method of augmenting water supplies and meeting needs on a regional or watershed basis.⁷⁶ Trading of surface water supplies occurs routinely through transactions that may be structured as leases, assignments, purchases, or even a trade of stock in a mutual water company.⁷⁷

Groundwater trading in adjudicated groundwater basins is also now very common in Southern California.⁷⁸ On the other hand, less trading has been

72. Cal. Const., art. X, § 2.

73. Barstow, 5 P.3d at 869; Allen v. Cal. Water & Tel. Co., 176 P.2d 8 (Cal. 1946); City of Lodi v. E. Bay Mun. Util. Dist., 60 P.2d 439 (Cal. 1936); Trussell v. San Diego, 343 P.2d 65 (1959).

74. Lindgren, *supra* note 14.

75. Water markets can play an important role in reallocating water to meet changing demands both among geographical regions and among water users with the same region. Thompson, *supra* note 19, at 701; Getches, *supra* note 15, at 12-13. See also HYMAN ET AL., *supra* note 14, at 245 (stating “[b]asically, some regions receive more rainfall than others or are natural storage basins due to the geology of the landscape”).

76. Closer examination reveals active markets. See Thompson, *supra* note 19, at 676, 722. Notably, Central Valley Project farmers have traded water within irrigation districts for many years. Water Educ. Found., *supra* note 6, at 17; see also 2000 Annual Transaction Review, Water Strategist, Feb. 2001, at 6; 2001 Annual Transaction Review, Water Strategist, Feb. 2002, at 7; Annual Transaction Review, Water Strategist, Feb. 2003, at 10; 2003 Annual Transaction Review, Water Strategist, Feb. 2004, at 10.

77. See WATER TRANSFER WORKGROUP, *supra* note 15, at 4.

78. See Ellen Hanak, *California's Water Market By the Numbers*, PUBLIC POLICY INSTITUTE OF

accomplished in unadjudicated basins because of the higher degree of uncertainty regarding the relative rights of the various users where overdraft conditions have prevailed for a number of years. In such areas, there is always the prospect that the rights of some users may be subordinated to the rights of previously dormant overlying lands, or if prescription can be proven, limited or benefited by application of prescriptive rights. Moreover, absent an adjudication, groundwater that might be claimed by overlying owners is generally not transferable.

Two examples of State administered water transfers exhibit just how effective transfers can be to address water shortages and with the supply of water for environmental protection. In 1991, following consecutive years of drought, the State Water Bank was established, and in that year it purchased the rights to use over 800,000 acre-feet of water from suppliers willing to sell to entities in critical need.⁷⁹ Additionally, the Environmental Water Account, in its first year of operation, obtained over 250,000 acre-feet of water from transfers, which were used in order to reduce the entrainment of fish at both state and federal pumping plants in the Bay/Delta region.⁸⁰

If, however, the Commission's primary goal was the development of a robust statewide water market, this goal has not been achieved.⁸¹ Inflated claims to water, referred to here as "paper water rights," may serve to frustrate the certainty of water rights proposed to be transferred. But, the most significant challenge to a more robust water market are: (i) the lack of a comprehensive statewide policy regarding the utilization of water conveyance and storage facilities; and (ii) the absence of clear rules to address third-party impacts.

CALIFORNIA, Oct. 2002, at 5; Chino Basin Watermaster, 26th Annual Report: Fiscal Year 2002-03, Draft app. A, P (Jan. 2004) (copy on file with the *McGeorge Law Review*); MARK WILDERMUTH, FINAL TECHNICAL MEMORANDUM; EVALUATION OF THE CUMULATIVE EFFECTS OF TRANSFERS PURSUANT TO THE PEACE AGREEMENT (Sept. 2003) (noting that several hundred thousand acre-feet of groundwater has been leased and transferred over the last five years); CAL. STATE BD. OF EQUALIZATION, *supra* note 36, at 5; WATER TRANSFER WORKGROUP, *supra* note 15, at 5. *See generally* Lee, *supra* note 40, at 57-70.

79. WATER TRANSFER WORKGROUP, *supra* note 15, at 4; Metro. Water Dist. of S. Cal. v. All Persons Interested in the Matter, No. BC 164076 (Super. Ct. L.A. County Aug. 19, 1997) (Declaration of David N. Kennedy at Exhibit A: Water Bank Supplies) [hereinafter Kennedy Declaration] (copy on file with the *McGeorge Law Review*).

80. WATER TRANSFER WORKGROUP, *supra* note 15, at 5.

81. Water transfers were expected to increase under the 1992 law, but proposed transfers outside the CVP service area have not gotten beyond the drawing board because of opposition from other local water users. Water Educ. Found., *supra* note 6, at 17; WATER TRANSFER WORKGROUP, *supra* note 15, at 5.

IV. THE REMAINING IMPEDIMENTS

A. Paper Water Rights⁸²

The vitality and seniority of a water right is always dependant upon relevant history of method, manner, location, and purpose of use. No amount of legislation can or should absolve a water user of its corresponding duty to use water in accordance with applicable law or to suffer the consequences for its failure.⁸³ Water users cannot be allowed to place this State's precious water resources into "cold storage"⁸⁴ without regard to the consequences of their actions.

The insistence of some users in the full recognition or acknowledgement of their paper claim often frustrates potential buyers and approving agencies. Short of a court decree in a comprehensive adjudication, there is very little in the way that paper alone can demonstrate.⁸⁵ For the buyer, the question is usually whether the seller has satisfactory use to coincide with the paper title and whether the relative reliability of the water right subject to transfer is worth the benefit of the bargain. The combination of the traditional "no injury rule"⁸⁶ created by the then existing baseline⁸⁷ and the environmental condition⁸⁸ make it unlikely that native water in excess of the right holders' consumptive use can be transferred.⁸⁹ With a fully developed market, a seller is forced to accept a more realistic view of their water right and to price it accordingly.

However stale, inflated and unrecorded claims of junior users can still chill potential transfers by increasing transaction costs in clearing contingencies and in forcing a transferor to demonstrate superior title. It only takes a protest of a pending transfer petition to increase costs and add to the delays in approving transfers. Today,

82. See SWRCB Order WR 99-12, *supra* note 52; SWRCB Order WR 2000-01, *supra* note 52; see also Planning and Conservation League v. Dep't of Water Res., 100 Cal. Rptr. 2d 173, 190-191 (Ct. App. 2000); Janet C. Neuman & Keith Hirokawa, *How Good is an Old Water Right? The Application of Statutory Forfeiture Provisions to Pre-Code Water Rights*, 4 U. DENV. WATER L. REV. 1 (2000).

83. Cal. Const. art. X, § 2; People ex rel. State Water Res. Control Bd. v. Forni, 126 Cal. Rptr. 851 (Ct. App. 1976); Imperial Irrigation Dist. v. State Water Res. Control Bd., 231 Cal. Rptr. 283 (Ct. App. 1986).

84. Cal. Trout, Inc. v. State Water Res. Control Bd., 255 Cal. Rptr. 184, 203-04 (Ct. App. 1989).

85. The value of a water right to a potential purchaser depends on a variety of factors. Jan P. Couter, *Hedonic Estimation Applied to a Water Rights Market*, 63 LAND ECON. 259, 262-63 (1987).

86. "[N]o injury" rules prohibit changes in water use that would harm downstream users by altering the amount, timing, or quality of the return flow." Thompson, *supra* note 19, at 703.

87. See generally County of Amador v. El Dorado County Water Agency, 91 Cal. Rptr. 2d 66 (Ct. App. 1999).

88. See generally *id.*

89. See SWRCB Order WR 99-12, *supra* note 52; SWRCB Order WR 2000-01, *supra* note 52; Cal. Water Code § 1725 (West Supp. 2005); SWRCB Order WR 2003-01, *supra* note 47 (where the water right to be transferred may have been forfeited for nonuse); see also Planning & Conservation League v. Dep't of Water Res., 100 Cal. Rptr. 2d 173, 191 (Ct. App. 2000) (stating that "[t]here is certainly the possibility that local decision makers are seduced by contractual entitlements and approve projects dependent on water worth little more than a wish and a prayer").

however, the primary impediment to realizing the goal of a more robust statewide water market is the lack of reliable access to natural and man-made conveyance systems.

B. Conveyance

1. Background

There was very little if any acknowledgement expressed by the Commission of the relationship between the desirability of making water rights more freely transferable and the ability to convey water to its proposed new point of use.⁹⁰ Yet once water transfers became a favored public policy, the potential sellers still faced significant challenges in their efforts to execute a transfer, particularly those seeking to transfer water out of watershed or out of basin.⁹¹

As was the case with other commodities early in the development of California, monopolies over the means to convey the resource from its point of origin to the point of use have presented challenges to the emergence of robust markets.⁹² Water, like oil or crops in the fields, is worth relatively little if the seller has little or no ability to bring the commodity to market.⁹³ Thus, while the Governor's Commission focused its attention on the need to bring certainty to water rights and to streamline transfer laws to make water available for transfer, there must be some framework to address the conveyance of transferred water if something more than intra-watershed or intra-basin transfers were to be facilitated.

Well before the Governor's Commission had been convened, the issue of accessing natural conveyance systems had largely been addressed by the State Legislature⁹⁴ and the Courts.⁹⁵ The laws applicable to obtaining access to the use of stream channels and groundwater basins and the rules governing their use remain

90. The Final Report of the Governor's Commission contains significant discussion of the manner in which California law could be modified in order to encourage water transfers. However, it does not discuss the facilitation of transfers or the impediments to the physical transfer of water.

91. Complexity of issues related to the use of state and federal conveyance facilities must be resolved, and interbasin transfers should be expedited. WATER TRANSFER WORKGROUP, *supra* note 15, at 15. See also HYMAN ET AL., *supra* note 14, at 245 (noting the importance of conveyance facilities to open markets).

92. HYMAN ET AL., *supra* note 14, at 250. Full protection of "lost sales" is equivalent to denying access to distribution facilities. ASSEMBLY COMMITTEE ON WATER, PARKS AND WILDLIFE, TESTIMONY ON SB 506 BY MAUREEN A. STAPLETON, GENERAL MANAGER, SAN DIEGO COUNTY WATER AUTHORITY (Aug. 9, 1999) (introduced by Senator Peace) [hereinafter STAPLETON TESTIMONY]. Transportation problems are not a trivial hurdle. Thompson, *supra* note 19, at 709 n.143; WATER TRANSFER WORKGROUP, *supra* note 15, at 4; Metro. Water Dist. of S. Cal. v. All Persons Interested in the Matter, No. BC 164076 (Super. Ct. L.A. County, Oct. 23, 1997) (Declaration of Richard Katz) [hereinafter Katz Declaration] (copy on file with the *McGeorge Law Review*).

93. HYMAN ET AL., *supra* note 14, at 245.

94. See CAL. WATER CODE §§ 7043 -7044, 7075 (West 1992).

95. See *Stevens v. Oakdale Irrigation Dist.*, 90 P.2d 58 (Cal. 1939); *Dunbar v. Humboldt Bay Mun. Water Dist.*, 62 Cal. Rptr. 358 (Ct. App. 1967); *Fell v. M. & T., Inc.*, 166 P.2d 642 (Cal. 1946).

relatively well defined. Accordingly, water trading within a given watershed or groundwater basin can be substantially easier to complete.⁹⁶

Conversely, access to and conveyance through man-made systems has triggered strong opposition when the facility owner is also a water supplier desiring to maintain monopoly control over its customer base.⁹⁷ The introduction of new water into that water supplier's facility gives rise to a potential loss of the facility owner's purchased water customers and creates a financial exposure where the owner is heavily reliant upon those same purchased water revenues to cover its fixed costs and it refuses to modify its rate structure.

2. Surface Channels

River channels, streams, creeks, and surface bodies of water, if navigable, are subject to a public right for a potential transferor to make use of the channel to convey water from one point to another. Specifically, Water Code section 7044 provides authorization to access the surface channel stating:

No legislative act shall prevent use or enlargement of any natural channel to convey water appropriated under the laws of this State, where the channel is designated as the means, or part of the means, of conveying the water so appropriated.⁹⁸

Water Code section 7075 then declares the right of any appropriator to reclaim water once it is introduced into a stream and commingled with native water.⁹⁹ Thus, by 1952, it was considered "common knowledge" that streams could be used as natural distribution systems to allow the conveyance of water.¹⁰⁰

Generally, the legal conditions to access and reclamation were essentially that the conveying party must not injure vested water right holders.¹⁰¹ Typically, this translated into the "duty of a commingler" to avoid interference with the quality or quantity of water that would otherwise be available to the existing water users. A party seeking to use a stream channel to convey water was free to negotiate their terms of access with affected landowners. However, there was no legal requirement that the party seeking to convey water through the available stream channel pay compensation to any of the riparians by which the conveyed water would pass.¹⁰²

96. Thompson, *supra* note 19, at 718-19; *see also* CAL. STATE BD. OF EQUALIZATION, *supra* note 36, at 5.

97. Institutions are the market barriers. Thompson, *supra* note 19, at 677. In purchasing institutions as a source of market distortion, wholesale agencies desire to protect their customer base. *Id.* at 755.

98. CAL. WATER CODE § 7044.

99. *Id.* § 7075.

100. 20 Op. Cal. Att'y Gen. 69, 70 (1952).

101. Stevinson Water Dist. v. Roduner, 223 P.2d 209 (Cal. 1950); Crane v. Stevinson, 54 P.2d 1100 (Cal. 1936).

102. In practice, this means that the party using the conveyance capacity probably has the risk of

3. Groundwater Basins

Like surface channels, groundwater basins are a public resource¹⁰³ of great importance in conveying water that may exist in one location to production in another. Recognizing the public policy benefits in using the available capacity in a groundwater basin to convey foreign or developed water, the California Supreme Court extended the benefits of the use of surface channels to groundwater basins under similar terms and conditions.¹⁰⁴

Modernly, groundwater basins are routinely used to transport and store water.¹⁰⁵ Where there has been an adjudication of the rights to that basin, the rules for access and recapture will be well known and may be administered by a watermaster.¹⁰⁶

Access to storage has always been important to structuring a water transfer. The existence of storage allows willing participants to structure their “puts and takes” in order to accommodate discrepancies in the water availability and water demand cycles. In other words, surface water hydrology in a given region may provide surface run-off at a time when there is insufficient demand to support a real-time transfer. However, by staggering the period of diversion and the period of distribution through the use of available storage within a groundwater basin, the parties may conserve water to meet long-term water supply needs. In so doing, seasonal or less reliable water supplies may be made “firm.”

The legal basis for using groundwater storage to facilitate a transfer is established by the court decrees in most adjudicated basins.¹⁰⁷ In unadjudicated areas, there are limitations to the use of basin storage capacity grounded in a duty

shortages unless there is a clear basis to demonstrate the amount of water that would otherwise be available in absence of the conveyance. Thus, even though it is often written that a riparian right does not attach to foreign or developed water, the burden falls upon the transferring party to demonstrate its reclamation will not cause harm.

103. See *Cent. & W. Basin Water Replenishment Dist. v. S. Cal. Water Co.*, 135 Cal. Rptr. 2d 486, 495-96 (Ct. App. 2003).

104. *City of Los Angeles v. City of Glendale*, 142 P.2d 289 (Cal. 1943); *City of Los Angeles v. City of San Fernando*, 537 P.2d 1250 (Cal. 1975).

105. See, e.g., *City of Los Angeles*, 537 P.2d at 1250; *Cent. & W. Basin Water Replenishment Dist.*, 135 Cal. Rptr. 2d at 486; *Alameda County Water Dist. v. Niles Sand & Gravel Co.*, 112 Cal. Rptr. 846 (Ct. App. 1974).

106. For example, the Chino Basin, in Los Angeles County, is administered by the Chino Basin Watermaster. See *Chino Basin Mun. Water Dist. v. City of Chino*, No. RCV 51010 (Super. Ct. San Bernardino County) (formerly Case No. 164327); WILLIAM A. BLOMQUIST, *DIVIDING THE WATERS: GOVERNING GROUNDWATER IN SOUTHERN CALIFORNIA* (1992); see also CAL. STATE BD. OF EQUALIZATION, *supra* note 36, at app. A (Watermasters-Contacts for Water Rights Transfers in Southern California).

107. Pursuant to the Chino Basin Peace Agreement, signed in 2000, the:

Watermaster shall approve the Transfer of water as provided in the [Chino Basin] Judgment so long as the individual Transfer does not result in any Material Physical Injury to any party to the Judgment or the Basin. Watermaster may approve a proposed Transfer with conditions that fully and reasonably mitigate any threatened or potential Material Physical Injury.

Chino Basin Peace Agreement, at 32 (June 29, 2000) (copy on file with the *McGeorge Law Review*).

to do no harm. Thus, available capacity within a groundwater basin may be used without compensation to overlying landowners up to the historic high water levels in the basin under natural conditions.¹⁰⁸ This right of storage is qualified, however, by certain restrictions which protect users of the basin's native waters. Stored imported water is the first to spill from a full basin and the rejected recharge could reasonably be charged to the storing party.¹⁰⁹ Furthermore, one may not recapture the water in a manner that causes physical harm to overlying lands.¹¹⁰

The potential for water quality degradation now looms as a larger legal impediment to the use of groundwater basins to implement water transfers. To the extent the imported water has *different* chemical constituents, it may cause problems for the users of native groundwater that have constructed treatment and distribution systems in reliance upon the water quality of local supplies. Recent decisions also suggest that a transferring party may also have obligations to comply with the Clean Water Act and obtain a National Pollutant Discharge Elimination System ("NPDES") permit even though they have added no chemicals to the transferred water ultimately recharged into a groundwater basin.¹¹¹

4. Man-Made Facilities

a. Background

While the law regarding the use of natural conveyance systems was well developed by the time of the Commissions Report in 1978,¹¹² there was little opportunity for (and perhaps even less law regarding the ability of) a willing buyer or willing seller to use man-made facilities. The general rule was that the owner of the facility retained its respective rights to condition the use of its property when responding to a request to use available capacity, without regard to whether there was excess capacity in the conveyance system.

Public agencies are immune from regulation by the California Public Utilities Commission¹¹³ and, prior to 1986, there was generally no recourse for a member of the public to contest a decision of a local agency to deny access to public facilities. Thus, to a large extent the facility owners controlled access to their own facilities and their decisions were beyond meaningful judicial review.

108. See *Niles Sand & Gravel*, 112 Cal. Rptr. at 851-53; Victor E. Gleason, *Water Projects Go Underground*, 5 *ECOLOGY L.Q.* 625 (1975).

109. *City of Los Angeles*, 537 P.2d at 1250.

110. *Los Osos Valley Assoc. v. City of San Luis Obispo*, 36 Cal. Rptr. 2d 758 (Ct. App. 1994).

111. See *N. Plains Res. Council v. Fidelity Exploration & Dev. Co.*, 325 F.3d 1155 (9th Cir. 2003); *Miccosukee Tribe of Indians v. S. Florida Water Mgmt. Dist.*, 280 F.3d 1364 (11th Cir. 2002).

112. See *supra* notes 47-49 and accompanying text.

113. *County of Inyo v. Pub. Util. Comm'n*, 604 P.2d 566 (Cal. 1980).

b. Apportionment and Improvements

At the time of the Commission's Report, the sole exceptions to the general right of local agencies to deny access to available capacity were found in Water Code sections 1775 and 1800, respectively. Neither statute was considered by the Commission.

Control of both these remedies lay within the discretion of the SWRCB.¹¹⁴ Water Code section 1775 provides that, where there is undeveloped capacity in a physical facility used to appropriate water under the Water Commission Act, another can make application to the SWRCB for apportionment of the available capacity so as to secure the right to complete a new appropriation or presumably a water transfer.¹¹⁵ Section 1775 allows person to apply to the SWRCB for a permit to utilize unused capacity of works (dams, tunnels, diversion works) when the owner will not or cannot develop the full capacity of the stream from which it appropriates water.¹¹⁶ The SWRCB can permit joint occupancy and use, and the applicant under section 1775 must pay a pro rata portion of the total cost of works, as well as maintenance costs.¹¹⁷ The statute requires that when determining whether to grant an application for joint occupancy and use, the SWRCB should take into consideration the following factors: the reasonable cost of the original and new works; the good faith of the applicant; the market for water to be supplied by the original and new works; and the income or use that may be required to provide fair and reasonable returns on the cost of the works.¹¹⁸

Similarly, Water Code section 1800 authorizes a party that desires to augment the facilities owned or controlled by another to apply to the SWRCB for the authorization to improve the existing facilities.¹¹⁹ Section 1800 allows a person to

114. CAL. WATER CODE §§ 1775, 1800 (West 1971).

115. *Id.* § 1775. Section 1775 provides:

If at any time it appears to the board, after a hearing of the persons interested and an investigation, that the full capacity of the works built or constructed, or being built or constructed, under an appropriation of water made pursuant to the Water Commission Act or this code has not developed or cannot develop the full capacity of the stream at the point where the works have been or are being built or constructed, and that the holder of the appropriation will not or cannot, within a period deemed to be reasonable by the board, develop the stream at that point to such capacity as the board deems to be required by the public good, the board may permit the joint occupancy and use, with the holder of the appropriation, to the extent necessary to develop the stream to its full capacity or to such portion of its capacity as may appear to the board to be advisable, by any persons applying therefor, of any such works.

Id.

116. *Id.*

117. *Id.*

118. *See id.* § 1776.

119. *Id.* § 1800. Section 1800 provides:

If it appears to the board that the full capacity of the works built or constructed, or being built or constructed, under an appropriation of water under the Water Commission Act or

apply to the SWRCB for a permit to repair, improve, or enlarge another's existing works when those works will not or cannot develop the full capacity of the stream.¹²⁰ The burden of improvement is solely upon the shoulders of the party desiring the improvement and they must also assume any subsequent maintenance costs attributable to their proposed improvements.¹²¹ The statute requires that, when determining whether to grant an application for joint occupancy and use, the SWRCB should consider the public good and should ensure that the repair or enlargement will not materially interfere with the proper use by the owner of the works nor materially injure them.¹²² Water Code sections 1775 and 1800 were originally adopted as part of section 12 of the Water Commission Act.¹²³ As with section 1800, "water works" are only subject to this power of the SWRCB under section 1775 if they were constructed under an appropriation "made pursuant to the Water Commission Act" or the Water Code, i.e., since December 19, 1914.¹²⁴ However, section 12 originally contained two paragraphs.¹²⁵

The first paragraph provided that the State Water Commission ("Water Commission") could impose on appropriators a time limit in which they were required to apply the full amount of water listed in their application to a beneficial use.¹²⁶ The second paragraph, which contained what later became sections 1775 and 1800 of the Water Code, provided, in part, that if at any time it appeared to the Water Commission that an applicant had constructed its water works and yet not used the full capacity of those works to "develop," i.e., divert water up to, the full capacity of the stream, and the appropriator "will not or cannot" develop the full capacity of the stream within a reasonable period of time, then the Water Commission could permit the joint use and occupancy of those works by any other party applying to do so.¹²⁷

this code, will not develop the full capacity of the stream at that point, and that the public good requires it, and the board specifically so finds after investigation and hearing of the persons interested, the board may permit any person to repair, improve, add to, supplement, or enlarge, at his own expense, any works already so built or constructed or in process of being so built or constructed under the provisions of this division, and to use the works jointly with the owners thereof.

Id.

120. *Id.*

121. *Id.*

122. *See id.* §§ 1800-1801.

123. A review of legislative history materials show that the paragraph that later became sections 1775 and 1800 were added to section 12 of Assembly Bill 642 on May 10, 1913. *See* 1913 Cal. Stat. ch. 586, sec. 12, at 1018. Sections 1775 and 1800 have been modified very little since enactment. They were incorporated into the Water Code basically unchanged in 1943, and amended once in 1957 to change references to the "commission" to the "board." *See* 1943 Cal. Stat. ch. 368, sec. 1775, at 1629; 1957 Cal. Stat. ch. 1932, sec. 128-131, at 3387. There have been no other amendments to section 1775 since that time.

124. CAL. WATER CODE § 1775.

125. *See* 1913 Cal. Stat. ch. 586, sec. 12, at 1018.

126. *See id.* For the modern version of this rule, *see* CAL. WATER CODE §§ 1395-1398.

127. *See* 1913 Cal. Stat. ch. 586, sec. 12, at 1018.

The subsequent applicant could be “any and all persons, firms, associations, or corporations applying therefor.”¹²⁸ Additionally, it provided that, under the same circumstances, the Water Commission could permit an applicant to “repair, improve, add to, supplement, or enlarge, at his or its proper costs, charge and expense” the works of another constructed under the Act, and to jointly use the facilities with the owners thereof.¹²⁹

The exact nature or form of the application to be filed by the party seeking to make use of or enlarge existing facilities was not specified in section 12, and has not been further clarified by the Water Commission or the SWRCB. Consequently, there remains some uncertainty as to whether the provision refers only to “new applicants” to appropriate water as described in Water Code section 1260 or a broader definition of “applicant” that would include prior appropriators requesting a change in their underlying water right to complete a transfer.

While a cursory review of the statutory language might suggest that these options were available only to “new applications” to appropriate water, there are at least three reasons that sections 1775 to 1801 are likely to be available to effectuate a transfer. First, under the Water Commission Act, the term “application” was used to denote a filing with the Water Commission for a change in the place of diversion as well as for a new appropriation.¹³⁰ Thus, the terms “application” or “applicant” should refer equally to either an appropriator seeking to make a change in an existing right or a new applicant filing to initiate an appropriation of water.

Second, the water policy of the state to promote and facilitate transfers would be served by the utilization of sections 1775 and 1801 by a party seeking to make a change under an existing right as much as by a party seeking to make a new appropriation of water.¹³¹ It is both economically wasteful and inefficient for a party seeking to change the point of diversion or the place of use to be forced to construct completely new facilities rather than avail themselves of the processes set forth in sections 1775 and 1801.

Third, the SWRCB has plenary power to enforce the provisions of the California Constitution under Article X, Section 2¹³² and it has extended its “public interest” evaluation to other subject matter not expressly articulated among the relevant criteria in reviewing transfers.¹³³ However, the exact process that would be used by the SWRCB in determining whether to permit joint use is unknown. It must involve fair notice and an opportunity to be heard, and it may include an investigation of facts by the SWRCB.¹³⁴ The SWRCB would also be

128. *See id.*

129. *See id.*

130. *See id.* sec. 16, at 1021-22.

131. *See id.* sec. 11, at 1017-18; CAL. CONST., art. X, § 2; CAL. WATER CODE § 100 (West 1971).

132. *Env'tl. Def. Fund, Inc. v. E. Bay Mun. Util. Dist.*, 605 P.2d 1, 6-7 (Cal. 1980).

133. *See SWRCB Revised Order WR 2002-13, supra* note 45, at 73-77.

134. CAL. WATER CODE §§ 1775, 1800 (West 1971).

required to require California Environmental Quality Act (“CEQA”) compliance before issuing a permit for enlargement and subsequent joint use.¹³⁵

If repair or enlargement is permitted by the SWRCB, the party making repairs or enlargements must pay for these repairs or enlargements.¹³⁶ If joint use is permitted by the SWRCB, the subsequent user must pay to the original owner of the works a pro rata portion of the total cost of any old and new works.¹³⁷ The subsequent user must also pay pro rata operations and maintenance costs incurred after beginning use or occupancy of the works.¹³⁸

There is little statutory guidance on what constitutes the “pro rata” shares of the original and subsequent users to be determined by the SWRCB, probably as part of the application process.¹³⁹ If the water is to be used for irrigation or domestic purposes, the pro rata portion must be based on the proportion of the water used by the original and subsequent users of the works, although whether the amount of water used by each party is calculated on an annual or long-term basis is not specified by the statute.¹⁴⁰ The “pro rata share” would likely equal the “capacity” right held by each of the parties in the diversion or conveyance works.

If the water is used for the generation of power, the pro rata portion of the costs is to be based on the relative amount of power capable of being developed by the original and new works.¹⁴¹ If a portion of the water is used for a combination of irrigation and power generation, the applicant is required to pay a pro rata portion of the total cost of the old and new works based upon the proportion of the relative amount of water used by each joint occupant and the income derived by each from the joint occupancy.¹⁴² On the other hand, if the water is used for purposes other than irrigation, domestic use, or power generation, the pro rata portion shall be determined by the SWRCB as appears to be “just and equitable.”¹⁴³

Not all water facilities are linked to water rights obtained under the Water Commission Act, thus they are beyond the reach of Water Code sections 1775 and 1800. Furthermore, not every proposed transfer calls for either the use of permanent capacity within existing facilities or the expenditure of millions of dollars for the construction of additional ones to convey the water. However,

135. See CAL. PUB. RES. CODE § 21065(c) (West 1996).

136. CAL. WATER CODE § 1800.

137. *Id.* § 1777.

138. *Id.* § 1782.

139. See *id.* § 1752. There are no SWRCB precedents for determining the pro rata portion of the cost of works the applicant is required to pay upon SWRCB approval of an application for joint use. There have been no reported cases, unpublished cases made available on Westlaw or LEXIS, or decisions by the SWRCB related to or interpreting Water Code sections 1750 through 1801.

140. See *id.* § 1778.

141. See *id.* § 1779.

142. See *id.* § 1780.

143. See *id.* § 1781.

sections 1775 and 1800 present a transferee/transferor, particularly in the case of a long-term or permanent water transfer, with two options for the conveyance of the water it is to receive.

c. *Space Available*

As stated above, sections 1775 and 1800 have never been utilized. And, by 1986, it had become evident that the legislative efforts previously envisioned by the Governor's Commission had not been sufficient to open up water markets to the extent anticipated.¹⁴⁴ Water conveyance facility owners had been successful in blocking voluntary water transfers by refusing access to available capacity in their canals and aqueducts.¹⁴⁵ Although it had been the State's policy for some time to encourage water transfers, there was no legislation that set forth a rational process to determine how canals and conveyance facilities might be used by prospective transferors.¹⁴⁶ Consequently, State Assemblyman Richard Katz introduced a bill in 1986 that was designed to remedy this situation by mandating that the owners of public water systems authorize the use of available capacity of their facilities to complete transfers.¹⁴⁷

Commonly referred to as the Katz Wheeling Bill, the bill ultimately signed into law by the Governor reflects an intention of providing opportunities for willing buyers and sellers of water to secure a right of access to man-made conveyance systems so long as they paid fair compensation to facility owners.¹⁴⁸ The bill sought to require water agencies to make unused capacity available for water transfers and provide a mechanism by which to determine reasonable compensation for that capacity's use.¹⁴⁹ Contrary to the focus of Water Code section 1775 on a permanent apportionment of capacity, the Katz law was instead focused on "space available" use. In other words, as in the case of wheeling water through natural conveyance systems, the potential transferors were required to do no harm; they could not displace the water supplies held by the owner of the facility.¹⁵⁰

The Katz Wheeling Bill provides that where the owner of a water conveyance system has unused capacity within its system, it must allow others to use the "water conveyance facilities" to transport water.¹⁵¹ These facilities are not

144. DEP'T OF WATER RES., ENROLLED BILL REPORT OF AB 2746, at 2-3 (Aug. 29, 1986) (noting that "[i]n some situations the owner has simply refused to allow others to use its facilities"); Katz Declaration, *supra* note 92, at 2.

145. Katz Declaration, *supra* note 92, at 2.

146. *Id.* at 3.

147. *Id.* at 3; A.B. 2746, 1986 Cal. Stat. ch. 918 (adding sections 1810-1814 to the Water Code).

148. Katz Declaration, *supra* note 92, at 3; CAL. WATER CODE § 1810-1814.

149. Katz Declaration, *supra* note 92, at 3; CAL. WATER CODE § 1810.

150. CAL. WATER CODE § 1810.

151. *Id.*

limited to aqueducts and canals, but also include local distribution systems.¹⁵² Should a transferor or transferee of water wish to utilize unused capacity within such conveyance facilities, the owner of the conveyance facilities must respond in a “timely manner.”¹⁵³

Questions regarding the implementation of a transferee’s rights under the Katz Wheeling Bill began to surface in 1996. The MWD and its largest customer, the SDCWA, were at loggerheads over whether section 1811(c) allowed MWD to set “fair compensation”¹⁵⁴ for the use of its facilities on some basis other than reimbursement for its actual costs incurred in accommodating a proposed transfer of Colorado River water from the IID to SDCWA.¹⁵⁵

While SDCWA contended that MWD was obligated to establish charges on a comparable basis to the method employed by the California Department of Water Resources (“DWR”)¹⁵⁶ on an actual facilities used, or “point to point” basis, MWD disagreed.¹⁵⁷ Although the express language of the statute strongly suggested that only those “costs incurred” in accommodating the transfer could be collected from the potential transferor,¹⁵⁸ MWD contended that it was entitled to exercise reasonable discretion in setting the rates for such fair compensation and that a system-wide cost recovery approach was available.¹⁵⁹ In making its argument, it essentially relied upon the historical discretion traditionally accorded to local agencies in their establishment of rates and on the language in section 1810 that incorporates the traditional “no-injury” rule.¹⁶⁰

The primary area of disagreement devolved from SDCWA’s unwillingness to hold MWD harmless against the loss of expected water sales to SDCWA if SDCWA were to secure an independent water supply for a portion of its water needs. MWD’s “wheeling rates” were established to price the cost of conveyance at roughly the same price as the cost of water delivered to SDCWA, inclusive of conveyance.¹⁶¹

Matters reached a flashpoint in the spring of 1997 and the California Legislature enacted emergency legislation that appointed the Director of Water Resources to issue a report on a proper wheeling charge or wheeling fee to be

152. *San Luis Coastal Unified Sch. Dist. v. City of Morro Bay*, 97 Cal. Rptr. 2d 323 (Ct. App. 2000).

153. CAL. WATER CODE § 1812.

154. “‘Fair compensation’ means the reasonable charges incurred by the owner of the conveyance system, including capital, operation, maintenance, and replacement costs, increased costs from any necessitated purchase of supplemental power, and including reasonable credit for any offsetting benefits for the use of the conveyance system.” *Id.* § 1811(c).

155. *See Metro. Water Dist. v. Imperial Irrigation Dist.*, 96 Cal. Rptr. 2d 314 (Ct. App. 2000).

156. Kennedy Declaration, *supra* note 79, at 8.

157. *Metro. Water Dist.*, 96 Cal. Rptr. 2d at 330-31.

158. CAL. WATER CODE § 1811(c).

159. *Metro. Water Dist.*, 96 Cal. Rptr. 2d at 331.

160. *See id.*; CAL. WATER CODE § 1810(d).

161. *Metro. Water Dist.*, 96 Cal. Rptr. 2d at 324-26.

applied to the Colorado River Aqueduct in the context of the emerging California 4.4 Plan for the Colorado River.¹⁶² Litigation also ensued in a validation action

162. CAL. WATER CODE § 1812.5 (repealed 1997). Enacted by SB 1082, section 1 of 1997 Cal. Stat. ch. 874 provided:

- (a) The Legislature finds and declares all of the following:
 - (1) This section is an extraordinary measure being taken only because the proposed transfer of conserved water from the Imperial Irrigation District to the San Diego County Water Authority is a matter of statewide interest in that it addresses a significant need for water in the southern state through the conservation of water now being consumed there. The Legislature further finds and declares that this section is not to be regarded as setting a precedent for any other legislative action.
 - (2) California's use of Colorado River water is limited to its basic annual apportionment of 4.4 million acre-feet, plus one-half of any excess or surplus water from the Colorado River. However, California continues to use up to 5.3 million acre-feet by relying on surpluses and apportioned, but unused water within the Colorado River Basin, which is not a reliable water supply. The Secretary of the Interior has strongly urged California to develop a plan to enable it to live within its basic apportionment of 4.4 million acre-feet from the Colorado River.
 - (3) It is of vital state interest that every effort be made to ensure that the Colorado River Aqueduct continues to operate at its full capacity at fair and reasonable terms in order to minimize statewide disruptions from diminishing Colorado River supplies.
 - (4) Negotiations assisted by the director are underway in 1997 between the Metropolitan Water District of Southern California and the San Diego County Water Authority for the development of a long-term wheeling agreement whereby the San Diego County Water Authority would use the Colorado River Aqueduct to wheel conserved water from the Imperial Irrigation district.
- (b) The director shall assist the Colorado River Board and the six California water agencies that derive water from the Colorado River in developing a plan to ensure that California can live within its entitlement of 4.4 million acre-feet of water annually and to ensure that the needs of southern California for Colorado River water are met.
- (c)
 - (1) Notwithstanding any other provision of law, with regard to the proposed transfer of conserved water from the Imperial Irrigation District to the San Diego County Water Authority, using the Metropolitan Water District of Southern California's water conveyance facilities, including the Colorado River Aqueduct, if the San Diego County Water Authority and the Metropolitan Water District of Southern California have not reached an agreement in principle on the terms and conditions of the transfer of conserved water using the Metropolitan Water District of Southern California's water conveyance facilities on or before August 15, 1997, the director shall issue a formal recommendation within 30 days from that date, with regard to the appropriate terms and conditions of the transfer.
 - (2) The director, in issuing a recommendation regarding appropriate terms and conditions of the transfer, shall make those determinations prescribed by Section 1812.
 - (3) If the director's recommendations prescribed by Section 1812 are unacceptable to either the San Diego County Water Authority or the Metropolitan Water District of Southern California, that party may request a formal mediation process. If both parties agree to participate in the formal mediation process, the parties shall commence mediation within one month after the mediation request is made. If the parties cannot agree on a mediator, the director shall appoint a mediator or the director may serve as mediator. The San Diego County Water Authority and the Metropolitan Water District of Southern California shall reimburse the state for any General Fund money used in mediation entered into pursuant to this paragraph.
- (d) No action taken pursuant to this section shall injure any legal user of water, and there

that MWD initiated by seeking judicial support of its wheeling rates in connection with its annual rate-setting process.¹⁶³

A short initial phase of a two phase trial was completed before Laurence Kay in early 1997 and a decision rendered in January of 1998 invalidated MWD's efforts to set fair compensation as an advance rate without regard to specific facilities that were actually used in the effectuating the transfer.¹⁶⁴ An exhaustive review of the legislative history of the Katz Wheeling Bill and the personal views of Richard Katz reflects a legislative intention to constrain the discretion of the local agency in setting its fee for fair compensation.¹⁶⁵ In fact, the bill's author, Richard Katz, also wrote letters to MWD encouraging it to modify its views to conform to their early efforts and representations when the bill was adopted.¹⁶⁶ From Assemblyman Katz's perspective, section 1810 pertained to those costs that were "solely attributable to the facility in question, and solely attributable to the use of the facility."¹⁶⁷ In his view, MWD was misinterpreting the law so as to block the then-proposed IID to SDCWA water transfer.¹⁶⁸

During the first phase of trial, SDCWA had sought to introduce an extensive package of legislative history regarding the meaning of various provisions of the bill, including a declaration from Richard Katz and several pieces of corroborating correspondence between Katz and MWD representatives.¹⁶⁹

shall be no shifting of costs for actions taken pursuant to this section to water users in any county in the State of California.

- (e) This section shall remain in effect only until January 1, 1999, and as of that date is repealed, unless a later enacted statute, that is enacted before January 1, 1999, deletes or extends that date.

Id.

163. *Metro. Water Dist.*, 96 Cal. Rptr. 2d at 316.

164. *Id.* at 327-28.

165. *See id.* at 319-22; Katz Declaration, *supra* note 92, at 6-13.

166. *See* Letter from Richard Katz, Assemblyman, to John "Woody" Wodraska, General Manager, Metropolitan Water District (Nov. 17, 1995) (copy on file with the *McGeorge Law Review*); Letter from Richard Katz, Assemblyman, to John Foley, Chairman of the Board, Metropolitan Water District (Nov. 1, 1996) (copy on file with the *McGeorge Law Review*); Letter from Richard Katz, Assemblyman, to N. Gregory Taylor, General Counsel, Metropolitan Water District of Southern California (Nov. 26, 1996) (copy on file with the *McGeorge Law Review*); Katz Declaration, *supra* note 92, at 9-13.

167. Letter from Richard Katz, Assemblyman, to John "Woody" Wodraska, General Manager, Metropolitan Water District 1 (Nov. 17, 1995) (copy on file with the *McGeorge Law Review*).

168. Letter from Richard Katz, Assemblyman, to John Foley, Chairman of the Board, Metropolitan Water District 2 (Nov. 1, 1996) (copy on file with the *McGeorge Law Review*).

169. SDCWA presented a declaration of Richard Katz in which he set forth the facts surrounding his introduction of the Katz Wheeling Bill, as well as his interactions with MWD regarding their differing interpretations of an appropriate wheeling fee under the statute. *See supra* note 167; *Metro. Water Dist. of S. Cal. v. All Persons Interested in the Matter*, No. BC 164076 (Super. Ct. L.A. County 1998) (Defendant SDCWA's Memorandum of Points and Authorities in Support of Declaration of Richard Katz). SDCWA attempted to have this introduced into evidence based on the California Supreme Court's decision in *Commodore Home Systems, Inc. v. Superior Court*, 649 P.2d 912 (Cal. 1982), in which the Court took judicial notice of various reports, letters, and legislators' memos dealing with the statutory amendments in the case. *See id.*

Although the trial court ultimately elected to focus on the plain meaning of the Katz Wheeling Bill rather than legislative history and, in fact, even refused to accept the Katz declaration into evidence, the trial court ruling concurred with the position of the multiple defendants in virtually every respect. In summary, the trial court decision held that “fair compensation” must be set to recover the actual incremental costs incurred in accommodating a transfer and that the general rate-making rules did not apply.¹⁷⁰ MWD appealed.¹⁷¹

While the case remained on appeal, the Director of the DWR was able to issue his report to the Legislature on the amount of an appropriate wheeling fee.¹⁷² In late summer of 1998, the issue became temporarily moot when the Legislature appropriated \$235 million for the lining of the All-American Canal as part of an agreement between SDCWA and MWD, whereby MWD was to receive substantial offsetting water supply benefits from canal lining in consideration for agreeing to exchange 200,000 acre-feet of water for SDCWA.¹⁷³

Under a contract known as the “Exchange Agreement,” MWD agreed to “exchange” water obtained by SDCWA from IID at a fee within the ranges previously recommended by Kennedy and that were generally reflective of MWD’s “point to point” costs.¹⁷⁴ However, the Exchange Agreement was carefully drafted to ensure that MWD would not have to cede the characterization of the conveyance agreement as a “wheeling contract” and so that it would receive the lion’s share of the benefits from the canal lining.

Though the Katz Wheeling Bill was crafted to cover many important aspects of water wheeling, as discussed *infra*, there are issues related to wheeling that have required judicial interpretation and will likely still require further legislative clarification. The legislature has unsuccessfully attempted to address some of these issues on two occasions.

Senator Steve Peace convened a stakeholder group during the summer of 1999 while the MWD validation case remained on appeal. Although the stakeholders were able to agree upon useful clarifying amendments regarding the inclusion of storage and treatment facilities and more defined administrative processes for the timely prosecution of wheeling requests, they were unable to reach agreement on whether “lost sales” could legitimately be recovered through an agency’s wheeling fee. In addition, methodology for determining a proper pro-ratio of capital costs where firm capacity was to be provided could never be

170. Metro. Water Dist. v. Imperial Irrigation Dist, 96 Cal. Rptr. 2d 314, 327-28 (Ct. App. 2000).

171. *Id.* at 317.

172. Pursuant to section 1812.5 of the Water Code, Director of Water Resources David Kennedy issued a report estimating a two-tiered wheeling fee during variable hydrologic conditions at \$80 and \$110 per acre-foot.

173. AGREEMENT FOR TRANSFER OF CONSERVED WATER BY AND BETWEEN IMPERIAL IRRIGATION DISTRICT AND SAN DIEGO COUNTY WATER AUTHORITY (Apr. 29, 1998).

174. *Id.*

agreed upon. In 2000, Senator Jim Costa subsequently tried to reconstitute the stakeholder group, but still no consensus emerged.¹⁷⁵

Subsequently, the construction of Water Code section 1810 received judicial construction and clarification in two California Court of Appeals decisions. In the first case, *San Luis Coastal Unified School Dist. v. City Morro Bay*,¹⁷⁶ the Second District Court of Appeal construed the terms “transferor” and “transferee” within the meaning of section 1810 to 1814.¹⁷⁷ In that case, a school district that had previously purchased water from the city negotiated a less expensive contract with the county.¹⁷⁸ In order to carry out its new contract, however, the District would require a wheeling agreement to convey the transferred water supply through the city’s facilities.¹⁷⁹ The City—anticipating lost profits from the new arrangement—refused to transport the water through their conveyance systems.¹⁸⁰

The District petitioned for and was denied a writ of mandate to compel the conveyance from the trial court.¹⁸¹ According to the lower court, section 1810 allowed only “transferors” of water to demand use of the City’s conveyance system and the school district was a “transferee.”¹⁸² However, on review, the Court of Appeal reversed, construing the meaning of “transferor” to include both buyers and sellers of transferred water.¹⁸³ This construction was based on the court’s recognition that, because the purchase and sale of water are inexorably linked, one cannot exist without the other.¹⁸⁴ Further, the court clarified that “transferor” refers, not to sellers, but to “an entity that transfers water from one place to another.”¹⁸⁵ As such, the District was a transferor within the meaning of section 1810 and the City could not deny it the use of the water conveyance facility with unused capacity.¹⁸⁶

The *Morro Bay* opinion also addressed the appropriate definition of the Wheeling Statute’s term conveyance “facilities.”¹⁸⁷ Although the City offered a narrow definition limited to canals and aqueducts, the Court of Appeals determined that “facilities” referred to not only canals and aqueducts but also local distribution facilities and allowed for the incidental storage and treatment required to complete the transfer.¹⁸⁸

175. See S.B. 621 (2002) (as amended in the Assembly on Aug. 28, 2002).

176. 97 Cal. Rptr. 2d 323 (Ct. App. 2000).

177. *Id.* at 325.

178. *Id.*

179. *Id.*

180. *Id.* at 326.

181. *Id.*

182. *Id.*

183. *Id.*

184. *Id.*

185. *Id.*

186. *Id.* at 328.

187. *Id.* at 327.

188. *Id.*

Finally, and even more definitively, the Court of Appeals rejected the City's claim that the school district's proposed use of its facilities for the sole purpose of reducing the cost of their water supply amounted to an impermissible "injury" under Water Code section 1810(d).¹⁸⁹ The City argued that the statute required that water transfers "promote efficient use of water" and that the District's use was intended to save money, not to conserve water.¹⁹⁰ In interpreting section 1810(d), the court disagreed and found that nothing prevented a party from using it for the sole purpose of reducing costs.¹⁹¹ Because lost sales were not the type of injury the statute protected, the District was entitled to transport water through the City's conveyance system.¹⁹² Said the Court:

But we do not believe the loss of income from a customer is the sort of injury to a legal user of water the Legislature had in mind. Neither Morro Bay nor its water customers have the right to make the school district purchase any particular amount of water. Although loss of a customer can cause financial difficulties, it does not amount to an injury.¹⁹³

The Katz Wheeling Bill was also addressed by a different Division within the Second Appellate District, however, with a directly conflicting result.¹⁹⁴ The Appellate Court heard the case on appeal from the Laurence Kay opinion, mentioned earlier, in which the trial court invalidated as a "matter of law" the MWD's practice of fixing wheeling rates in advance based on the volume of water transported and including system-wide costs without regard to the actual costs incurred in wheeling the water.¹⁹⁵

On appeal, as they had done successfully in the trial court, the respondents argued that any damages arising from lost sales were unrecoverable under the Katz Wheeling Bill and that the statutes required that the fees for wheeling services be linked to the actual costs incurred by MWD in transporting the water.¹⁹⁶ The Court of Appeal disagreed with the trial court, however, declaring that the Legislature would have expressly provided that it wanted to preclude the use of a system-wide methodology to protect against potential lost sales, if it had intended to do so.¹⁹⁷ The court also rejected the defendant's argument that MWD

189. *Id.* at 328.

190. *Id.* at 327.

191. *Id.*

192. *Id.* at 328 (referring to Water Code section 1810, the court stated that nothing in the statutory scheme gave the city the right to deny the school district the use of its water conveyance system because it wanted more money).

193. *Id.*

194. *Metro. Water Dist. v. Imperial Irrigation Dist.*, 96 Cal. Rptr. 2d 314 (Ct. App. 2000).

195. *Id.* at 316.

196. *Id.* at 330-31. The defendants argued that a wheeling charge for a particular transaction must be calculated with respect to point-to-point use of the facilities and system-wide costs should not be included. *Id.*

197. *Id.* at 333.

was required to set rates on a case-by-case basis.¹⁹⁸ Because the Katz Wheeling Bill requires timely rate setting, the Court of Appeal held MWD's fixed rate practice effectuated, rather than violated, the statute's purpose.¹⁹⁹ Additionally, contrary to the conclusion reached in the *Morro Bay* case, the *Metropolitan* Court held that the owner of conveyance facilities could, as part of its wheeling charge, recover for lost sales stating:

There is no indication the Legislature ever intended that the water conveyance system owner should suffer potential or actual financial loss as a result. Rather, the Legislature took repeated steps to enact compensatory language that would enable water conveyance system owners to provide the desired wheeling service while recovering their costs. In short, the Legislature did not intend that the impact of the Wheeling Statutes should be to cause a water conveyance system owner to lose money or to subsidize wheeling transfers.²⁰⁰

The *Metropolitan* and *Morro Bay* opinions clearly conflict regarding whether the Wheeling Bill allows the recovery of costs associated with lost sales. The *Metropolitan* opinion additionally allows for an abstract rate to be set in advance of a transfer.²⁰¹ On both of these points, the cases appear to be inconsistent.

Viewed from a policy perspective, the result in the *Morro Bay* case clearly seems to be more in line with both California law and with the recommendations of the Governor's Commission to facilitate transfers. If, under California law, water is to be put to reasonable use,²⁰² and it is the policy of the State to promote transfers,²⁰³ the Katz Wheeling Bill cannot be read in a fashion that would allow the owner of conveyance facilities to set its wheeling charge for unused capacity in such a fashion as to create a barrier to the effectuation of a water transfer. State law and policy demand that, although a facility owner receives fair compensation for the utilization of facilities,²⁰⁴ the facility owner not be allowed to prevent water transfers based on a desire to preserve its own market position. At a minimum, the existing conflict between the opinions in *Morro Bay* and *Metropolitan* creates one more element of the uncertainty that leads to inefficient water resource utilization and must be resolved.

198. *Id.* at 335.

199. *Id.*

200. *Id.*

201. *Id.* at 336.

202. CAL. CONST. art. X, § 2.

203. CAL. WATER CODE § 109 (West Supp. 2005).

204. *Id.* § 1810-1814.

d. *Looking Ahead: Potential Wheeling Issues*

A central issue in the consideration of future wheeling is the cost that must be paid to the owner of the conveyance facilities as “fair compensation.” The problems with the approach adopted in *Metropolitan* are numerous.

Like other owners of water conveyance systems, MWD’s desire to protect its position in the marketplace and control its largest customer is obvious and understandable.²⁰⁵ But why should Californians’ accept the inherent conflict that is implicit in a situation where the owner of the conveyance system is also the supplier of water to a party seeking to execute a transfer?

With regard to wheeling, it has been observed that “[w]e do not allow United Airlines to own airports,” and the monopoly power associated with “wheeling” of any underlying commodity,” whether the commodity is “water aqueducts, electricity, natural gas, or telecommunications,” must be undertaken by an enterprise that is neutral to the cost and terms of the transaction.”²⁰⁶

Transportation problems related to the conveyance of water are not a trivial hurdle.²⁰⁷ Access to pumping plants in the Sacramento/San Joaquin Delta and canal capacities are major factors in accomplishing water transfers from the northern portions of the Central and Southern areas of California.²⁰⁸ If potential transferors cannot pay the costs of securing wheeling rights through facilities owned by public agencies, inter-basin transfers are likely doomed for any parties other than the facility owners. There does remain some hope, as not all facility owners are as protectionist as MWD. Kern County has long assessed merely an incremental cost methodology. It can do this largely because, unlike MWD, it has instituted a rate structure that allows it to recover its fixed costs without regard to the volumetric sales of its water.²⁰⁹

205. See HYMAN ET AL., *supra* note 14, at 250 (stating that SDCWA’s purchase of IID’s conserved water “would represent one of the first cracks in the MWD’s monopoly”); Somach & Hitchings, *supra* note 38, at 26 (noting that “certain regulatory agencies sometimes act in dual roles within the transfer process”); STAPLETON TESTIMONY, *supra* note 92; Cf. ASSEMBLY COMMITTEE ON WATER, PARKS AND WILDLIFE, TESTIMONY ON SB 506 BY GERALD A. GEWE, ASSISTANT GENERAL MANAGER FOR WATER, L.A. DEP’T OF WATER & POWER (Aug. 9, 1999) (introduced by Senator Peace).

206. Robert Fellmeth, *Plunging into Darkness: Energy Deregulation Collides With Scarcity*, 33 LOY. U. CHI. L.J. 823, 862 (2002).

207. Thompson, *supra* note 19, at 709 n.143.

208. WATER TRANSFER WORKGROUP, *supra* note 15, at 4. The only mention of the subject was in a footnote in the introduction.

209. See RICHARD E. HOWITT ET AL., INTEGRATED ECONOMIC ENGINEERING ANALYSIS OF CALIFORNIA’S FUTURE WATER SUPPLY 72 (Aug. 1999) (CALVIN report); U.S. BUREAU OF RECLAMATION, INTERIM GUIDELINES FOR IMPLEMENTATION OF THE WATER TRANSFER PROVISIONS OF THE CENTRAL VALLEY PROJECT IMPROVEMENT ACT, DRAFT (rev. Feb. 19, 1993); U.S. BUREAU OF RECLAMATION, RECLAMATION MANUAL DIRECTIVES AND STANDARDS WTR 04-01: USE OF EXCESS CAPACITY IN RECLAMATION PROJECTS FOR THE IMPOUNDMENT, STORAGE, AND CARRIAGE OF NON-PROJECT WATER (Nov. 2000) (supplementing and providing implementation guidelines for the Reclamation Manual policy WTR P04). Both of the State’s major export projects, the State Water Project (“SWP”) and the Central Valley Project (“CVP”), take differing approaches to wheeling costs for use of

Assuming that the financial challenges could be overcome, there is still a matter of water quality that will have to be addressed. Just as in the case with differences in the quality of water conveyed through natural conveyance systems, facility owners may use water quality concerns as justification for their decision to further increase the cost of access, or deny it entirely.

Water Code section 1810 states that:

The commingling of transferred water does not result in a diminution of the beneficial uses or quality of the water in the facility, except that the transferor may, at the transferor's own expense, provide for treatment to prevent the diminution, and the transferred water is of substantially the same quality as the water in the facility.²¹⁰

While 1810 suggests that a transferor may elect to pay for the additional treatment costs, what constitutes "diminution" is unclear. Does *any* change in water quality or in the concentration of each constituent, such as total dissolved solids, or a contaminant such as chromium, constitute diminution? The legislature or the courts will likely have to answer this question if open access to man-made systems is to be obtained.

e. Anti-Competitive Conduct

Section 1 of the Sherman Act expressly precludes anti-competitive monopolies and collusion that restrain competition.²¹¹ Section 2 prohibits predatory and anti-competitive conduct through the acquisition of monopoly power.²¹²

To establish a colorable claim, generally a plaintiff must prove that the conduct has a "not insubstantial effect" on interstate commerce.²¹³ The restraint must injure competition in the relevant market.²¹⁴

MWD owns and controls the major regional water supply and distribution systems throughout its service area. It owns and controls the only water conveyance

their facilities. For contractor-to-contractor transfers, the SWP charges only for the power necessary for conveyance. However, the SWP is not as generous to non-contractors interested in wheeling through SWP facilities, and they must pay pro-rated capital charges but still on a "point-to-point" basis with charges to non-contractors also covering capital costs as well as incremental charges based on reach used. Additionally, non-contractors must supply the power necessary for conveyance or pay a non-contractor power rate. The U.S. Bureau of Reclamation, in connection with its oversight of the CVP, charges wheeling of non-CVP water by requiring the transferor to pay for necessary power and withholding any benefits of incidental power generation from their water. However, excess capacity in CVP facilities may only be used for water that will be put to use for irrigation and drought control purposes. See Kennedy Declaration, *supra* note 79, at 7.

210. CAL. WATER CODE § 1810(b) (West Supp. 2005).

211. 15 U.S.C.A. § 1 (West Supp. 2005).

212. *Id.* § 2.

213. *Pinhas v. Summit Health Ltd.*, 894 F.2d 1024, 1031-32 (9th Cir. 1989), *aff'd*, 500 U.S. 322 (1991).

214. See *Nat'l Soc'y of Prof'l Eng'rs v. United States*, 435 U.S. 679 (1978).

facilities that connect many of its member agency customers to the rest of Southern California and the balance of the MWD service area.

When it adopts an all-inclusive set of wheeling and conveyance charges, that when combined, approach or equal the price of water it sells to its customers, there is little if no opportunity for a potential buyer or seller to secure water from a supplier other than Metropolitan at a competitive price.²¹⁵

The Sherman Act does not apply to anticompetitive restraints imposed by the States “as an act of government.”²¹⁶ Thus, when an entity that owns essential water conveyance facilities and at the same time is seeking to maintain its market share, the question arises as to whether the public agency that is acting in an anti-competitive manner can be held responsible.²¹⁷ A government entity may gain “*Parker* immunity” from the Sherman Act provisions if state policy authorizing restraints on competition is a foreseeable result of the grant of regulatory authority to such an entity.²¹⁸ If it is the declared policy of the State to facilitate water transfers and California Constitution Article X, Section 2 mandates the reasonable use of water, then it would appear that a local agency that sought to establish barrier pricing to access common carrier facilities might have some responsibility under the Sherman Act. However, given the federal case law view that California countenances the anti-competitive conduct, antitrust concerns do not seem to have had an effect.

The applicability of the Sherman Act antitrust provision arose in the water content case of *Kern-Tulare Water District v. City of Bakersfield*,²¹⁹ where the City of Bakersfield refused to consent to the Kern-Tulare Water District’s transfer of water provided to the District under contract with the City.²²⁰ Although the

215. Mark P. Berkman & Jesse David, *Water Wars: Part II: Water Subsidies in Southern California: Do They Exist and Have They Contributed to Urban Sprawl? A Comment on an Article by Steven P. Erie and Pascale Joassart-Marcelli Titled “Unraveling Southern California’s Water/Growth Nexus: Metropolitan Water District Policies and Subsidies for Suburban Development, 1928-1996*, 37 CAL. W. L. REV. 121 (2000).

216. *Parker v. Brown*, 317 U.S. 341, 352 (1943). The Court explained that the Sherman Act was meant to apply to the actions of individuals, not to state actions: “The Sherman Act makes no mention of the state as such, and gives no hint that it was intended to restrain state action or official action directed by a state.” *Id.* at 351.

217. Gary D. Weatherford, *Liquid Transfers*, THE RECORDER, Jan. 11, 1994, at 7 (noting that “[p]rotective barriers restraining trade in California are primarily public affairs”).

218. *Kern-Tulare Water Dist. v. City of Bakersfield*, 828 F.2d 514, 518 (9th Cir. 1987), *cert. denied*, 486 U.S. 1015 (1982); *see also* *Hedgecock v. Blackwell Land Co.*, 1995 WL 161649 (9th Cir. 1995) (unpublished disposition).

219. 828 F.2d at 514.

220. *Id.* at 516.

plaintiff prevailed at trial, the Ninth Circuit Court of Appeals reversed the District Court's determination that, in refusing to consent to such a transfer, the City had lost its *Parker* immunity, as its actions had resulted in the waste of water, in contravention to the California policies favoring efficient use and free transfer of water.²²¹ The Court found that it was the State of California's policy to "displace competition with regulation in the area of municipal control over water and water rights, so long as the municipality does not engage in waste or unreasonable use."²²² When viewed in light of such a policy, the Court found that the City's refusal to consent to the District's attempted transfer was an action *contemplated by the legislature* in its grant to the City of the ability to acquire water rights for the provision of water to its inhabitants, and to dispose of any surplus water.²²³

The Court reasoned that, in empowering municipalities to acquire, purvey, and dispose of water, the Legislature must have contemplated, that in the exercise of those power, "cities might act by contract to preserve access to water for existing and future uses."²²⁴ A city's ability to do so was found to be protected so long as the city did not engage in waste or unreasonable use.²²⁵ The Court found that the City's refusal to allow the District to transfer unneeded water did not constitute such waste or unreasonable use.²²⁶

The Court's broad extension of *Parker* immunity to municipalities wishing to maintain a secure water supply amounts to the express allowance of barriers to water transfers.²²⁷ Apparently not wasteful or unreasonable, the Court's decision stands for the proposition that a municipality may impose barriers to the type of efficient water use that the Governor's Commission wished to promote. On the other hand, some have argued that the *Kern-Tulare* decision may not be the last word.²²⁸ A rationale that supports governmental immunity to foster prudent governmental regulation can hardly be squared with a water supplier's efforts to restrict competition by foreclosing access to essential water conveyance facilities.

221. *Id.* at 519.

222. *Id.*

223. *Id.* at 519-20.

224. *Id.* at 520.

225. *Id.*

226. *Id.* The Court found the oversight of the SWRCB regarding the waste and unreasonable use of water to be a sufficient safeguard to protect against "the likelihood that a city will be able to waste or unreasonably use water before another potential user can avail itself of recourse." *Id.* at 521.

227. Weatherford, *supra* note 217.

228. Somach & Hitchings, *supra* note 38, at 26 (stating that "[w]hile the Kern-Tulare case is important for its analysis of California's and other western states' pervasive regulation of water rights and water use, the case is probably most significant for the limits of its holding").

C. Non-Traditional Third Party Impacts

The issue of whether those persons that indirectly benefit from an existing water diversion and use may have a legal status to protest or block a transfer is an open question. So-called “non-traditional” third-party rights have been the subject of law review commentary,²²⁹ some legislative acknowledgement,²³⁰ and even a screenplay.²³¹ The SWRCB approval process is designed to ensure that the public interest and third-party rights are not impaired by the transfer. Traditionally, however, a party that did not have a legally recognized interest in the water supply to be transferred generally has no standing to object to a water transfer.²³² However, the public interest is always an important consideration in SWRCB determinations, and modern standing before the SWRCB has been more liberal.²³³ While the public interest review of the SWRCB is often equated with ensuring the protection of fish, wildlife, and the environment, there is no requirement that the SWRCB limit its review to these issues.²³⁴

In the context of the *Imperial Transfer* decision, a conservation transfer, the issue arose as to the benefits and impacts associated with specific methods of conservation.²³⁵ It was alleged that different forms of conservation would cause different benefits and impacts, and the impacts that were thought to potentially result from a specific choice juxtaposed the concerns of non-traditional third parties against fish, wildlife and recreation.²³⁶

The essence of the dispute in *Imperial Transfer* was that non-traditional interests opposed land fallowing as a specific means of conservation, because it was alleged that this method of conservation would cause socio-economic impacts within the surrounding community.²³⁷ On the other hand, because fish and wildlife might be adversely impacted by a reduction in return flows associated with on-farm conservation focusing on irrigation efficiency, fallowing

229. See George Gould, *Water Rights Transfers and Third-Party Effects*, 23 LAND & WATER L. REV. 1, 20-21 (1988); Charles Howe, *Protecting Public Values in a Water Market Setting: Improving Water Markets to Increase Economic Efficiency and Equity*, 3 U. DENV. WATER L. REV. 357, 372 (2003); Hanak & Dyckman, *supra* note 17, at 491-92; Aaron Ralph, *Drain the Water and Pull the Plug on the Economy at One Community So that Another Community Can Brim Over with Economic Development: Is it Any of the SWRCB's Business?*, 34 MCGEORGE L. REV. 903, 918-21 (2003).

230. See S.B. 479 (2003) (as introduced on Feb. 20, 2003, but not enacted). Introduced by Senator Mike Machado, SB 479 would have authorized the SWRCB to approve petition for long-term water transfers only if it additionally determines that the proposed transfer would not cause substantial, negative third party impacts.

231. THE MILAGRO BEANFIELD WAR (Universal Pictures 1988) (based on the book by John Nichols).

232. *Vineland Irrigation Dist. v. Azusa Irrigating Co.*, 58 P. 1057, 1060 (Cal. 1899).

233. CAL. WATER CODE § 1702 (West 1971); see S.W.R.C.B., Order No. WR 95-09, at 29 (June 22, 1995) [hereinafter SWRCB Order WR 95-09].

234. CAL. WATER CODE § 1702; SWRCB Order WR 95-09, *supra* note 235, at 29.

235. See SWRCB Revised Order WR 2002-13, *supra* note 45.

236. *Id.*

237. See *id.* at 73-77.

was also considered as a more environmentally benign method to generate conserved water for long-term transfer.²³⁸

Several SWRCB rulings are of special interest. First, the SWRCB concluded that the community's interest did not constitute that of a "legal user" of water, but nevertheless held that the nontraditional third-party rights could be considered by the SWRCB in its public interest balancing.²³⁹ The SWRCB so held based on its conclusion that its public interest review of long-term transfers was comparable to that involved in approving an initial application to appropriate.²⁴⁰ Accordingly, the SWRCB determined that it could consider the socio-economic impacts of fallowing on the personal incomes of employees and business owners within Imperial County.²⁴¹ The SWRCB held that:

The SWRCB has authority to consider whether the transfer would be in the public interest in view of the potential socio-economic impacts of fallowing. In evaluating proposed changes in a water right permit or license, including changes that will allow a transfer to take place, the SWRCB considers the same factors that it considers when evaluating a water right application, including whether the changes will be in the public interest.²⁴²

In support of this position, the SWRCB cited to several sections of the Water Code governing its consideration of general applications to appropriate water.²⁴³ In reaching its decision, the SWRCB rejected the SDCWA's contention that there was no legal basis for the SWRCB's consideration of socio-economic impacts because the Water Code provisions governing long-term transfers²⁴⁴ did not expressly provide for an evaluation of whether a long-term change would be in the public interest.²⁴⁵ Instead, the SWRCB concluded that the language of Water Code section 1736 extended the SWRCB's discretion, similar to that present when it approves an amendment in a permit or license.²⁴⁶ In the SWRCB's view, neither the Water Code nor public policy supported a statutory construction precluding the SWRCB from considering the public interest (or in this case the socio-economic effects of fallowing) as part of its review of a change petition, "when the SWRCB would be required to consider the public interest if the change had been proposed as part of the original application."²⁴⁷

238. *Id.*

239. *Id.* at 21-23, 73-74.

240. *Id.* at 73-74.

241. *Id.*

242. *Id.*

243. *Id.* at 74; see CAL. WATER CODE §§ 1253, 1255, 1256 (West 1971).

244. CAL. WATER CODE § 1726.

245. SWRCB Revised Order WR 2002-13, *supra* note 45, at 74 n.21.

246. *Id.*

247. *Id.*

The SWRCB ultimately concluded that it might be feasible to minimize the potential economic effects and to mitigate those that could not be eliminated and found that the transfer would be in the public interest, notwithstanding the potential socio-economic effects that fallowing might produce because those effects should be minimized and mitigated.²⁴⁸

Instrumental to its finding was Senate Bill 482,²⁴⁹ which provided a process by which any socio-economic impacts of the transfer would be evaluated and mitigated.²⁵⁰ In summary, the bill required the Resources Agency and the Technology, Trade and Commerce Agency to submit to the Legislature a report prepared in consultation with both IID and Imperial County evaluating the nature and extent of economic impacts of fallowing in the County associated with the transfer, measures taken by IID to minimize such impacts, and the extent to which funds in excess of the funds received by IID for water transferred might be necessary to mitigate such impacts.²⁵¹ The SWRCB was satisfied that this procedure would address the potential socio-economic impacts of the transfer and reserve continuing jurisdiction pending the outcome of the Agencies' report to consider whether additional measures were necessary to minimize or mitigate such impacts.²⁵² Accordingly, the SWRCB effectively accepted the surrogate for the authority it deemed itself to possess. However, the lack of guidance regarding the process or outcome in situations where there is no express legislative authorization or SWRCB surrogate has added a significant element of uncertainty for those seeking long-term water transfers.²⁵³

In approving the IID Transfer, the SWRCB concluded that it possessed the power to condition a transfer on the basis that it had the authority to so condition the initial appropriation of water. Yet, in no case has the SWRCB ever assigned a financial requirement of mitigating financial impacts on the area in which water originates. Perhaps this is so because the law effectively embeds a preservation of local values through the State's adoption of the dual system of riparian and appropriative rights in the *Lux v. Haggin*²⁵⁴ decision. Given that the export of

248. *Id.* at 74.

249. 2002 Cal. Stat. ch. 617.

250. SWRCB Revised Order WR 2002-13, *supra* note 45, at 74.

251. *Id.* at 77.

252. *Id.*

253. See Ralph, *supra* note 231, at 918 (stating that “[n]ot only does the SWRCB fail to state what standard of review is used to determine whether the socio-economic impacts are sufficiently minimal to approve the transfer, but it does not even define the term ‘socio-economic impact’”).

254. *Lux v. Haggin*, 10 P. 674 (Cal. 1886). The opinion states:

In our opinion, it does not require a prophetic vision to anticipate that the adoption of the rule, so called, of “appropriation” would result in time in a monopoly of all the waters of the state by comparatively few individuals, or combinations of individuals controlling aggregated capital, who could either apply the water to purposes useful to themselves, or sell it to those from whom they had taken it away, as well as to others. Whether the fact that the power of fixing rates would be in the supervisors, etc., would be a sufficient guaranty against over-charges would remain to be tested by experience. Whatever the rule laid down, a monopoly or

water for appropriative use must always be subordinate to the local riparian and overlying water requirements, there is likely to always be a reservation of some water for local needs. With that said, there is still no instance in which the SWRCB has imposed a financial barrier in the form of community compensation to address the local economic impacts associated with the appropriation of water. Even CEQA does not require the analysis of purely economic impacts.

The SWRCB, though undertaking a detailed approval process, has never imposed an economic mitigation fee to offset perceived socio-economic impacts of an appropriation. This includes its approval processes for large appropriations of water to be used outside the county, area, and even watershed where the water to be appropriated originates. For example, the SWRCB has approved large-scale water appropriations for use in both the State Water Project (“SWP”) and the federally operated Central Valley Project (“CVP”). However, the SWRCB has not considered the socio-economic impacts on the area of origin of allowing water originating in one location to be utilized elsewhere. It is at least worth observing that if there is a valid public interest concern regarding the impacts of a transfer on an area that has long been allowed to reap the benefits of imported water, then there must be exposure for any appropriator that has removed water from a watershed in any case where the SWRCB has maintained continuing jurisdiction over the license or the permit.

A potential water transferee, seeking to most economically supplement its existing water supply, is now faced with the uncertainty surrounding the possibility that the SWRCB may require mitigation of the potential socio-economic impacts of a transfer. But, though the SWRCB has declared itself to have the power to do so, in the IID to SDCWA transfer discussed *supra*, the SWRCB deferred to State agencies to analyze the socio-economic impacts and refrained from clarifying what additional costs a prospective transferee must now consider in its contemplation of a water transfer. Further questions abound.

What is the duty and role of the local agency seeking to transfer water to account for socio-economic impacts? What is the role of the local city or county? Who should be the arbiter of the proper course of conduct and appropriate level of mitigation where the views of one or more local agencies conflict? What is the standard for measurement? Does a transferor get a credit or reimbursement for third parties when it creates economic stimulus through a conservation-based transfer? In the absence of further clarification,²⁵⁵ the potential transaction costs associated with any given transfer are difficult, if not impossible to predict and the exposure to this uncertain and potentially unquantifiable duty will have a chilling effect on future transfers.

concentration of the waters in a few hands may occur in the future.

Id. at 703.

255. See Ralph, *supra* note 231.

V. CONCLUSION

Subject to some limited exceptions, the Legislature and the courts have combined to provide greater certainty and security to water rights in California. The statutory addition of Water Code section 1011 holds great promise for parties seeking to transfer water so long as the conservation-based transfers are generally within the historic consumptive use of the transferor, as they are likely to result in fewer socio-economic impacts. However, if California desires a more robust water market, one that can truly be a powerful tool in meeting our mounting water supply deficits, further reform will be required.

Whether the ultimate responsibility for further reform will lie within the Legislature or the courts is unclear. However, specific improvements in two discrete areas should help.

First, with regard to wheeling, further articulation of the basis for establishing “fair compensation” under the Wheeling Statutes is essential. A state legislative declaration that otherwise anti-competitive municipal conduct in blocking third-party transfers is not anticipated, condoned, or acceptable state policy may serve to change the result under the only federal case to consider the subject and discourage a facility owner from blocking transfers in an effort to keep its customers captive.

As an alternative, the Legislature could consider removing the responsibility for establishing “fair compensation” for wheeling from the owner of the conveyance system and vesting that authority in an independent entity. The facility owner has an inherent conflict of interest in setting the fee for fair compensation where the owner’s customer is the party requesting a transfer. The SWRCB wields a similar and independent responsibility under Water Code sections 1775 to 1801, and it should be well positioned to implement the provisions of Water Code section 1810.

Second, the subject of socio-economic impacts must be addressed through the articulation of a standard that defines the scope and measure of a transferor’s obligation to mitigate socio-economic impacts. A water transferor seeking to understand whether a specific contemplated transfer will trigger indirect “non-traditional” third-party impacts and to what degree they will be responsible for mitigation may find very few satisfactory answers. It is difficult to argue that some members of a community may be harmed but, on the other hand others may be benefited. Moreover, the imposition of an arbitrary standard that fixes a mitigation fee without regard to the form of conservation employed and whether there are actually positive socioeconomic impacts that result from the transfer is unwise and will only serve to discourage rather than promote transfers. If public policy demands that socio-economic impacts be addressed, then California needs a clearly defined standard, which provides for a credible measurement of socio-economic effects, so that potential transferors will be able to realistically gauge the transaction costs triggered by a proposed trade.

Without these or other similar measures that address these issues, the 50-year anniversary of the Commission’s Report will likely find us with only limited and

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decidedly local water markets. For some, this will be the realization of a vision to curtail California's economic expansion or to force yet further conservation efforts. For others, it will be yet one more failed effort to augment future water supply needs that serves as the rationale to build new and bigger water supply projects. But for most Californians, it will only spell a collective failure to secure a future consistent with sustainable management and development of our State's precious water resources in an economically efficient and environmentally responsible way.